

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

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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

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Memo to: Clients
From: Howard Marks
Re: Microeconomics 101: Supply, Demand and Convertibles

Two principal factors determine whether an investment will be successful. The first is the intrinsic quality of the underlying entity being invested in. In short, how good is the venture you are buying a piece of or lending money to? It's better to invest in a good company than a bad one, ceteris paribus,

[Ceteris paribus is a favorite term of economists. It means “everything else being equal,” and yes, at a given price, it's smarter to invest in a better company than a worse one. Of course, “everything else” never is equal, and you're not likely to be asked to choose between two assets of obviously different quality at the same price.]

The second factor determining whether something will be a good investment is price. Ceteris paribus, given two assets of similar quality, it's better to pay less than more.

Lots of investors take the approach of searching out companies with better products, managements, balance sheets and prospects. Many say they will only buy top quality assets.

Our group does not have that luxury and, at any rate, pursuing museum quality assets would be antithetical to our philosophy. In convertibles, as in high yield bonds and certainly in distressed debt, our companies generally are not widely applauded or atop the ratings heap. Instead, they fall within a broad range in terms of quality.

We are less concerned with the absolute quality of our companies than with the price we pay for whatever it is we're getting. In short, we feel “everything is triple-A at the right price”. We have many reasons for following this approach, including the fact that relatively few people compete with us to do so. But we feel buying any asset for less than it's worth virtually assures success. Identifying top quality assets does not; the risk of overpaying for that quality still remains.

What does all of this have to do with microeconomics? Well microeconomics is the study of the price-setting process, and much of price comes down to a matter of supply and demand.

Ceteris paribus -- in this case, holding the level of supply constant -- price will be higher if there is more demand and lower if there is less. And that's why buying when everyone else is can, in and of itself, doom an investment. Many real estate investments made in the 1980s were ill-fated because excess demand from investors and too-easy credit induced builders to erect structures for which there are no tenants. Many of the later LBOs failed because excessive demand pushed prices for companies to levels which were

too high given their prospects.

Conversely, buying what no one else will buy at any price almost assures eventual success, and that leads to a discussion of the current level of demand for convertibles and its impact on their prices.

I wrote this summer that convertibles tend to capture most of the upside performance of stocks while being significantly insulated from declines, and that such performance characteristics should be attractive given the high level of uncertainty today. What I didn't mention -- and what I want to point out now -- is that one of the factors contributing to the availability of bargains among convertibles is the relatively low level of demand for them.

Here in 1992, strong demand has supported stock prices. Important among the components of that demand is the heavy flow into mutual funds of cash fleeing from low-yielding short term investments. But flows into convertible funds have been low, as indicated by the following clipping from Barron's. The figures are worth reviewing.

Convertible securities funds don't get much respect. They had a great 1991, when they rose 30%, matching the S&P 500, and so far this year, they're up 3.5%, while the S&P is down a fraction. This showing is impressive since convertibles, bond-equity hybrids, are usually a more conservative choice than stocks, trailing the S&P in bull markets and falling less than stocks in down markets.

Yet investors, normally quick to snap up anything offering better yields than CDs and money-market funds are staying away. Assets of convertible funds stood at \$2.36 billion on June 30, up just \$100 million since the start of the year, and way below their peak of \$5.3 billion just before the 1987 crash.

Between 1977 and 1984, the number of convertible mutual funds was constant at seven, and at the end of that period their total assets stood at the princely sum of \$452 million. By the end of 1987 there were thirty funds with assets of \$5.8 billion, for a thirteen-fold increase. It can clearly be seen in retrospect that the strong flow of capital into convertibles in 1985-87 "poisoned the well" and led to a loss of price discipline, to purchases of over-priced securities, and to poor performance.

Reaction was negative, and convertible mutual fund assets dropped to \$3.2 billion at year-end 1989 and only \$2.2 billion today, down 62% from the 1987 level. If strong inflows are, as I believe, a precursor of poor performance (and vice versa), then the outlook today should be excellent. Convertibles are getting no respect and attracting no inflows. That leaves bargains for those willing to act as contrarians. We hope you will consider convertibles an attractive way to hold an increased portion of your commitment to equities.

October 8, 1992

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Memo to: Clients

From: Howard Marks, TCW

Re: The Value of Predictions, or Where'd All This Rain Come From?

Anyone who has been my client for long has heard from me on many occasions with negative comments about market forecasts. Now, I have decided to say at once all of the bad things I can think of about predictions.

The Expected Value of a Forecast = Value of Correct Forecast x Probability of Being Correct

The motivation for trying to guess the direction of stocks or bonds is easy to understand. Observers have for years noted the wide price swings, calculated the value of a dollar invested at the bottoms and disinvested at the tops and compared the result against the value of a dollar invested under a "buy-and-hold" strategy. The difference is always temptingly large.

The problem, however, comes from the fact that none of the forecaster's attempts to capture the swings have any value unless his or her predictions are right.

But It's Hard to be Right

I agree with John Kenneth Galbraith. He said "We have two classes of forecasters: Those who don't know -- and those who don't know they don't know." If it was easy to predict the future, it would be easier to attain excellent investment results -- then maybe everyone could have above-average performance.

Being Right With Average Consistency Doesn't Help

Let's face it: most of us have roughly the same ability to predict the future. And the trouble is that being right as often as the average forecaster won't produce superior results.

Every investor wants results which are above average. In the institutional world, relative performance is the Holy Grail. Even elsewhere, the objective is to be the first to see the future -- and take the appropriate route to profit. It obviously doesn't help in these pursuits to be right only as often as others are.

An Average Forecast Doesn't Help Even If It's Correct

Being "right" doesn't lead to superior performance if the consensus forecast is also right. For example, if the consensus forecast for real GNP growth is 5%, then stock prices will come to reflect that expectation. If **you** then conclude that GNP will grow at 5% and your expectation of rapid growth motivates you to buy stocks, the stocks you buy will be at prices which already anticipate such growth. If actual GNP growth at 5% is subsequently announced, stock prices probably will not jump -- because their reaction to 5% growth took place when the consensus forecast was arrived at. Instead, the best guess is that you will earn the normal risk-adjusted return for equities over your holding period. Bottom line: **correct forecasts do not necessarily translate into superior investment results.**

Above-Average Profits Come From Correctly Forecasting Extreme Events

At least twenty-five years ago, it was noted that stock price movements were highly correlated with changes in earnings. So people concluded that accurate forecasts of earnings were the key to making money in stocks.

It has since been realized, however, that it's not earnings changes that cause stock price changes, but earnings changes **which come as a surprise**. Look in the newspaper. Some days, a company announces a doubling of earnings and its stock price jumps. Other earnings doublings don't even cause a ripple -- or they prompt a decline. The key question is not "What was the change?" but rather "Was it anticipated?" Was the change accurately predicted by the consensus and thus factored into the stock price? If so, the announcement should cause little reaction. If not, the announcement should cause the stock price to rise if the surprise is pleasant or fall if it is not.

This raises an important Catch 22. Everyone's forecasts are, on average, consensus forecasts. If your prediction is consensus too, it won't produce above-average performance even if it's right. Superior performance comes from accurate non-consensus forecasts. But because most forecasters aren't terrible, the actual results fall near the consensus most of the time -- and non-consensus forecasts are usually wrong. The payoff table in terms of performance looks like this:

		Forecast	
		Consensus	Non-Consensus
Accurate?	Yes	Average	Above Average
	No	Average	Below Average

The problem is that extraordinary performance comes only from correct non-consensus forecasts, but non-consensus forecasts are hard to make, hard to make correctly and hard to act on.

When interest rates stood at 8% in 1978, most people thought they'd stay there. The interest rate bears predicted 9%, and the bulls predicted 7%. Most of the time, rates would have been in that range, and no one would have made much money.

The big profits went to those who predicted 15% long bond yields. But where were those people? **Extreme predictions are rarely right, but they're the ones that make you big money.**

Most Forecasts are Extrapolations

The fact is, most forecasters predict a future quite like the recent past. One reason is that things generally continue as they have been; major changes don't occur very often. Another is that most people don't do "zero-based" forecasting, but start with the current observation or normal range and then add or subtract a bit as they think is appropriate. Lastly, real "sea changes" are extremely difficult to foretell.

That's why some of the best-remembered forecasts are the ones that extrapolated current conditions or trends but were wrong. Business Week may never live down "The Death of Equities" and "The Death of Bonds." At the mid-1990 lows, the press suggested that no one would ever buy a high yield bond again. In 1989, nobody thought the Cowboys would ever win without Tom Landry, or that the Lakers or 49ers would ever lose. Six years ago, the growth of both coasts' economies was considered assured, and the Rustbelt's suffering was expected to continue forever. Only two years ago, George Bush was a shoe-in.

And that brings me to my subtitle: Where'd All This Rain Come From? The motivation for this memo came as I considered the extraordinary amount of precipitation the West has experienced this year -- and newspaper articles of a couple of months ago. According to the articles, the rings on old trees suggested that fifty year droughts might be the norm and the five year drought to date just the beginning.

No one predicted the drought before it began -- when such a forecast might have helped. But just as it may have been about to end, the possibility of its long-term continuation was unveiled.

Forecasters are Usually Most Wrong at the Extremes

It's at just such times --- such inflection points -- when accurate forecasts of change would be the most valuable but are the hardest to make.

Take high yield bonds, for instance. In 1989 and 1990 they absorbed a continual beating as a series of negative developments came together. There was the recession, the failure of a number of the leveraged buyouts of the 1980s, enactment of excessively stringent regulation and the collapse of Drexel Burnham, Columbia Savings and Executive Life. All of this was tied together -- and accentuated -- by lots of overly negative publicity.

Each development was another drip of "Chinese water torture." Each one put an end to some investor's ability to remain optimistic. And so each one eliminated a potential buyer, created a seller and moved prices lower.

And after all, what is a market bottom? It's that moment when the last holder who will become a seller actually does so -- and thus the moment when prices hit levels that will prove to have been the lows. From that point on, with no one left to turn negative, a few pieces of good news or the arrival of a few buyers with belief in values are enough to turn a market.

So you can see that the crescendo of negativism, the lowest prices and the greatest difficulty in predicting a rise all occur simultaneously. No wonder it's hard to profit from forecasting.

Extreme Forecasts are Hard to Believe and Act On

Let's say the average investor was approached in October 1990 by someone who had enough imagination and courage (because that's what was needed) to make a positive case for high yield bonds. Would the investor have believed and bought? Probably not.

Potentially-profitable non-consensus forecasts are very hard to believe and act on **for the simple reason that they are so far from conventional wisdom**. If a forecast was totally logical and easily accepted, then it would **be** the consensus forecast (and its profit potential would be much less).

So if someone told you the U.S. auto makers' share of domestic market was going back to 100% in five years, that would be a forecast with enormous implications for profit. But could you possibly believe it? Could you act on it?

The more a prediction of the future differs from the present, (1) the more likely it is to diverge from the consensus forecast, (2) the greater the profit would be if it's right, and (3) the harder it will be to believe and act on it.

You Have to Be Right About Timing Too

Not only must a profitable forecast have the event or direction right, but it must be correct as to timing as well.

Let's say you accepted the forecast that the Big Three would come to again own 100% of the U.S. market, and you bought the stocks in response. What if a year later their share was lower (and their stocks too)? Could you continue to hold out for the long term, or would your resolve weaken? What if their shares (and stocks) were unchanged five years later? Wouldn't you give up? And wouldn't that be just in time to see the prediction come true?

In poker, "scared money never wins." In investing, it's hard to hold fast to an improbable, non-consensus forecast and do the right thing...especially if the clock is telling you the forecast is off base. As I was told years ago, "**being too far ahead of your time is indistinguishable from being wrong.**"

Incorrect Forecasts Can Cost You Money

As you know, we run our portfolios without reference to what we think the broad markets will do. An observer might think such behavior exposes us unduly to the fluctuations of the markets, and that to protect our clients we should actively go in and out of the markets based on what we think will happen.

But remember, that will work only if our forecasts are right (and right more often than the consensus is right). I would argue that because forecasting is uncertain, it's safer **not** to try.

For example, people hold equities because they find prospective long-term equity returns attractive. The average annual return on equities from 1926 to 1987 was 9.44%. But if you had gone to cash and missed the best 50 of those 744 months, you would have missed **all** of the return. This tells me that **attempts at market timing are a source of risk, not protection.**

It would be nice in anticipation of subsequent performance to be able to vary the amount invested, but I think it's just too risky to try.

It Costs Money to Make Forecasts

As suggested above, the best thing might just be to settle for average long-term performance in markets that are hard to predict.

Efficient marketeers think stock market forecasts are about as good as coin tosses. If you're right half the time **without bias**, your forecasts won't help or hurt versus buy-and-hold. But

forecasts are implemented through transactions which cost money. If you're right half the time **and spend money to try**, your performance will fall further below buy-and-hold results the more trading you do.

Few People Revisit Their Forecasts

We always read "I think the stock market's going to go up." We never read "I think the stock market's going to go up, (and 8 out of my last 30 predictions were right)" or "I think the stock market's going to go up (and by the way I said the same thing last year and was wrong)." Can you imagine deciding which baseball players to hire without knowing their batting averages? When did you ever see a market forecaster's track record?

Most Forecasts Don't Allow for Alternative Outcomes

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 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 will be correct and the portfolio will perform as expected.

And what if some other scenario unfolds? How will the portfolio do? How do the forecaster/investors make allowances in their portfolios for the likelihood that their predictions will prove incorrect?

Lastly, Ask Yourself "Why Me?"

By this I mean "if someone has made a potentially valuable forecast with a high probability of being right, why is it being shared with you?"

Think how profitable a correct market forecast could be. With very little capital, a good forecaster could make many times more in the futures market than in salary from an employer. Okay, let's say he likes to work for other people -- than why does his employer give his forecasts away rather than sell them? Maybe the thing to ask yourself is whether you would write out a check to buy the forecast you're considering acting on.

Groucho Marx said "I wouldn't join any club that would have me as a member."
Another formulation may be "I would never act on any forecast that someone would share with me." I'm not saying that no one has above-average forecasting ability. Rather, 'as one University of Chicago professor wrote in a paper years ago, such forecasters are more likely to be sunning themselves in Saint Tropez than going around entreating people to borrow their forecasts.

* * *

There is a bottom line for us on the subject of predictions regarding macro-scale events and widely-followed markets about which information is rather evenly disseminated (so-called efficient markets). In sum, we feel that:

most forecasters have average ability

consensus forecasts aren't helpful

correct non-consensus forecasts are potentially very profitable but are also hard to make consistently and hard to bring yourself to act on

forecasts cost money to implement and can be a source of risk rather than return

The implications for us are clear. We will continue to eschew portfolio management based on forecasts of market trends, about which we think neither we nor anyone else knows much.

Instead, we will continue to try to "know the knowable" -- that is, to work in markets which are the subject of biases, in which non-economic motivations hold sway, and in which it is possible to obtain an advantage through hard work and superior insight. We will work to know everything we can about a small number of things...rather than a little bit about everything.

Convertible securities, high yield bonds and distressed company debt are all markets in which market inefficiencies give rise to unusual opportunities in terms of return and risk. We will continue to exploit these opportunities in a manner which is risk-averse **and non-reliant on macro-forecasts.**

February 15, 1993

. . . [predictions] ought to serve but for winter talks by the fireside.

Sir Francis Bacon

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Random Thoughts on the Identification of Investment Opportunities
Howard S. Marks -- January 24, 1994

1. **No group or sector in the investment world enjoys as its birthright the promise of consistent high returns.**

There is no asset class that will do well simply because of what it is. An example of this is real estate. People said, "You should buy real estate because it's a hedge against inflation," and "You should buy real estate because they're not making any more." But done at the wrong time, real estate investing didn't work.

2. **What matters most is not what you invest in, but when and at what price.**

There is no such thing as a good or bad investment idea per se. For example, the selection of good companies is certainly not enough to assure good results -- see Xerox, Avon, Merck and the rest of the "nifty fifty" in 1974.

Any investment can be good or bad depending on when it's made and what price is paid. It's been said that "any bond can be triple-A at a price."

There is no security that is so good that it can't be overpriced, or so bad that it can't be underpriced.

3. **The discipline which is most important in investing is not accounting or economics, but psychology.**

The key is who likes the investment now and who doesn't. Future prices changes will be determined by whether it comes to be liked by more people or fewer people in the future.

Investing is a popularity contest, and the most dangerous thing is to buy something at the peak of its popularity. At that point, all favorable facts and opinions are already factored into its price, and no new buyers are left to emerge.

The safest and most potentially profitable thing is to buy something when no one likes it. Given time its popularity, and thus its price, can only go one way: up.

Watch which asset classes they're holding conferences for and how many people are attending. Sold-out conferences are a danger sign. You want to participate in auctions where there are only one or two buyers, not hundreds or thousands.

You want to buy things either before they've been discovered or after there's been a shake-out.

4. **The bottom line is that it is best to act as a contrarian.**

An investment that "everyone" knows to be undervalued is an oxymoron. If everyone knows it's undervalued, why haven't they bought it and driven up its price? And if they have bought, how can the price still be low?

Yogi Berra said, "nobody goes to that restaurant; it's too popular." The equally oxy-moronic investment version is "Everybody likes that security because it's so cheap."

5. **Book the bet that no one else will.**

If everyone likes the favorite in a football game and wants to bet on it, the point spread will grow so wide that the team -- as good as it is -- is unlikely to be able to cover the spread. Take the other side of the bet -- on the underdog.

Likewise, if everyone is too scared of junk bonds to buy them, it will become possible for you to buy them at a yield spread which not only overcompensates for the actual credit risk, but sets the stage for their being the best performing fixed income sector in the world. That was the case in late 1990.

The bottom line is that one must try to be on the other side of the question from everyone else. If everyone likes it, sell; if no one likes it, buy.

6. **As Warren Buffet said, "the less care with which others conduct their affairs, the more care with which you should conduct yours." When others are afraid, you needn't be; when others are unafraid, you'd better be.**

It is usually said that the market runs on fear and greed. I feel at any given point in time it runs on fear or greed.

As 1991 began, everyone was petrified of high yield bonds. Only the very best bonds could be issued, and thus buyers at that time didn't have to do any credit analysis -- the market did it for them. Its collective fear caused high standards to be imposed. But when investors are unafraid, they'll buy anything. Thus the intelligent investor's workload is much increased.

7. **Gresham's Law says "bad money drives out good." When paper money appeared, gold disappeared. It works in investing too: bad investors drive out good.**

When undemanding investors appear, they'll buy anything. Underwriting standards fall, and it gets hard for demanding investors to find opportunities offering the return and risk balance they require, so they're forced to the sidelines.

Demanding investors must be willing to be inactive at times.

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Memo To: Clients

From: Howard S. Marks, TCW

Re: Risk in Today's Markets

The ability of the stock market to react so harshly on February 4 to a small, Fed-mandated rise in interest rates, pushing the Dow down 96 points, suggests a lack of preparedness for negative developments. This prompts me to write to you about certain risks I feel may be present in the markets today.

There are plenty of bullish arguments to be made about the prospects for the economy and corporate profits, and pundits to make them. While I will not devote space or time to them, I don't pretend they are nonexistent. And I won't deny the possibility that as an inherently cautious investor, I sometimes tend to overstate the negatives. What I want to do, however, is point out the degree to which I feel investors are behaving in a risk-tolerant manner today, and the implications for all of us.

Two very powerful trends are at work, and have been for the last few years. The first is the decline in interest rates, which has carried rates to the lowest levels of the last thirty years and brought on great dissatisfaction with the returns available from low-risk fixed income investments. The second is the fabulous performance which was produced by virtually all investments in securities from 1991 to 1993. This was a period in which risk-taking was rewarded, and almost without exception very high returns went to those who took great risk.

Put these two phenomena together and what do you have? I think the answer is an environment in which risk-taking is greatly encouraged.

It is often said that the market runs on fear and greed, but I believe it usually runs on fear or greed; that is, at most points in time, one or the other predominates. Right now, because of the two trends cited above, greed is greatly elevated and, perhaps more importantly, fear is in short supply. Thus,

- the money market investor, not content to earn 3% per year, (a negative return after taxes and inflation), turns to notes and bonds,
- the bond investor, unhappy with returns at the shorter (read "low-risk") end of the curve, extends maturities,
- the high grade bond investor drops down in quality,
- the fixed income investor turns to equities,
- the equity investor joins a hedge fund,

- the domestic investor looks overseas,
- the international investor emphasizes emerging markets, and
- the traditional bond-and-stock investor searches for "alternative investments" likely to repeat the success of the LBO and bankruptcy funds.

And why shouldn't they? The "stick" is the low prospective return offered in each investor's traditional bailiwick, and the "carrot" is the high returns earned recently in the riskier sectors. In brief, "why should I settle for 3% in T-bills when I can get double-digit returns in stocks?"

There are numerous signs of infatuation with -- or non-questioning acceptance of -- the pursuit of high returns. The torrential inflow of dollars to mutual funds is one; I recently attended a conference at which a fund group representative said they were taking in \$100 million a day, 90% of it for foreign funds. The rising level of margin debt is another. Books on investing are reaching the best-sellers list. The names of hedge fund managers are almost household words.

And that brings me, for purposes of illustration, to the subject of hedge funds. When I first got to know the money management community twenty years ago, only a handful of managers were good enough to command a share of the profits as compensation. Today, according to a recent article in Forbes, there are 800 hedge funds, and some people think being accepted by one of the big names is the chance of a lifetime.

I think it's important to remember, though, the symmetrical nature of most investments: almost every sword is two-edged, and he who lives by a risky strategy may die by it. Investments which will make you a great deal of money when things go well but not lose you a lot when things go poorly are very rare, and their existence must presuppose extremely inefficient markets. With the average stock or bond returning 10-15% last year, how did some hedge funds make 70% or more? It was through bold and heavily-leveraged plays on macro-developments such as currency movements. What would have happened if the managers' calculations had proved wrong? The hedge fund manager I know with the best performance last year, up more than 100%, is said twice in his life to have lost 30% in one day! Do the hedge fund aficionados know how much risk they are taking? For how long are they tying up their money? How much do they know about the strategies being employed? As the Forbes article pointed out, the sum of the "information" most hedge fund investors receive is a quarterly paragraph reporting the rate of return.

I am not complaining about the fact that there are hedge funds, or about their popularity. My point is simply that the level of risk borne by investors is being systematically raised, often unknowingly and at a time when many valuations are quite high.

Comparison against low interest rates makes low earnings yields and dividend yields seem tolerable. Likewise, low rates increase the discounted present value of companies' future earnings as calculated by valuation models. For these reasons and others, many valuation indicators are at levels today which have proved dangerous and unsustainable in the past. Just as today's low interest rates are pushing investors toward riskier securities all along the "food chain" described above, however, this sword can also cut the other way.

Warren Buffet said, in one of my favorite adages, "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." Another adage I'm fond of is, "What the wise man does in the beginning, the fool does in the end." No course of investment action is either wise or foolish in and of itself. It all depends on the point in time at which it is undertaken, the price that is paid, and how others are conducting themselves at that moment.

When everyone shrinks from a security because it's "too risky," the few who will buy it can do so with confidence, secure in the knowledge that the price has not been bid up, and in the likelihood that others will eventually outgrow their fear and jump on the bandwagon. Today, many prices have been bid up, and the bandwagon is already crowded with wild-eyed investors.

It is my view that, first, few of the trends being pursued are at their beginnings; money has been flowing to today's popular sectors for at least a year or two. Second, while some may argue that prices are not forbiddingly high, it's almost impossible to argue that they're very low (or that the easy money hasn't already been made). Third, it seems to me that investors are accepting higher levels of risk throughout the system.

Here's one illustration: Our cautious high yield investing saved clients a lot of money and heartache in 1989 and 1990. Because we apply in-depth, downside-conscious credit analysis to the high yield segment of the bond market, and define it narrowly, investors who were chastened by the last decline and don't want to bear the full brunt of the next one have hired us repeatedly in the years since. Now, however, we detect increased interest in more "eclectic" managers who will buy cash-paying or non-cash-paying bonds, going concerns or bankruptcies, convertible or straight bonds, and U.S. or foreign debt. This is just one example, near to us, of the new acceptability of risk -- at what just might be the wrong time.

Too-low interest rates and too-high prices may prove at some point to have set the stage for a correction. If so, many of the riskier tactics to which recent trends are pushing investors will increase the extent to which that correction is felt. What course of action, then, would we argue for?

We do not preach risk-avoidance. In fact, the knowing acceptance of risk for profit is at the core of much of what we do, and we feel there is an important role today for investing which is creative and adaptable. But we would take this opportunity to exhort you to review most critically the risk associated with your current and contemplated

investments, and not to be among those who uncritically joined the trend toward risk. Whatever investment opportunities you decide on, we would encourage you to stress thorough appraisal of the risks entailed and cautious implementation.

What is it that distinguishes the investment opportunities we'd suggest you pursue today? Not just the offer of high returns, but of returns which are more than proportionate to the risk entailed. The reason we champion inefficient markets (such as the high yield bonds, convertibles and distressed debt we're involved with) is that there exists by definition the potential, if exploited correctly, for an uncommonly favorable ratio of return to risk.

Exploitation of opportunities in inefficient markets; insistence on preserving capital; refusal to pursue maximum return at the cost of maximum risk; specialization rather than dabbling; heavy emphasis on careful analysis; use of less-risky senior securities -- these themes have been the cornerstones of our approach over the years. They remain highly relevant and should continue to be pursued by all of us, especially at this point in the cycle.

February 17, 1994

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Memo To: Clients

From: Howard S. Marks, TCW

Re: "Risk in Today's Markets" Revisited

Seven weeks ago, we put out a memorandum entitled "Risk in Today's Markets." Its essence was that the excellent returns earned in risky strategies through 1993 had eroded the fear factor in many markets and, coupled with the low yields available on conservative fixed income investments, had caused many investors to take "one giant step forward" on the risk curve. It also pointed out that just as declining rates had acted to raise prices and generate good returns, rate movements could cut the other way too. Lastly, it cautioned that when others are acting imprudently, driven by greed and without much fear, it is important that we raise our level of prudence.

Unfortunately, the events of the intervening seven weeks have shown these observations to be in order. It is the purpose of this follow-up memo to review the developments of the intervening time period, attempting to make sense out of what has happened and searching for lessons that can be drawn. It's about understanding basics of investing which don't come and go.

The current "correction" dates from February 4, when the Federal Reserve Bank raised short term interest rates a small amount in order to choke off inflationary thought and action. The air quickly came out of the bond markets, and the decline has been swift and deep. Although there were good days for a while as well as bad, the bond market never did recover its equilibrium once the rate rise had begun. The yield on the 30-year Treasury bond rose from 6.21% on January 28 to 7.40% on April 4, with its price falling 14%, from 100.41 to 86.22. The decline spread quickly to other asset classes, and many investors in riskier strategies suffered harsh consequences.

Some observers protest that economic and industry fundamentals continue to be favorable. But those positive developments had come to be valued too highly, and the resulting correction of valuations has been painful. It's important to note the first lesson, then: successful investing has at least as much to do with what you pay for an asset as it does with what that asset's fundamentals are.

But why did the Fed's half-point bump up in short rates cause such devastation? First, of course, even a small step in terms of policy-related tightening implies there may be much more to come. More importantly though, the move suddenly took a big bite out of investors' optimism and reawakened their fear. Through January, investors acted as if nothing could go wrong. That first rate rise served to remind them that something could go wrong -- and had. Thus there has been a swing back from a euphoric extreme.

After the Fed's raising of rates opened their eyes to the negatives, investors also took notice of the tensions with Korea, Japan and China, the strength of the yen, and

uncertainty over Whitewater. At the same time, Mexico's stock market had its own correction, in reaction to the assassination of the leading presidential candidate. The important lesson to be learned here is that whenever market participants act as if nothing can go wrong (or right), that represents an extreme swing of psychology -- of the pendulum we wrote about in April 1991 -- that must be recognized for what it is and acted on. As Roseanne Rozanadana used to say on Saturday Night Live, "it's always something." Investment actions predicated on everything continuing to go well are bound to fail.

If the spark that set off the decline in bond prices was the rate increase, why did the slump spread to so many other markets, including equities, foreign bonds, and commodities? Where were the benefits of strategic diversification? I would respond citing the following factors:

- First, interest rates affect the value of everything. Investing consists of putting out money today in order to get more back at a later date. The "discounted present value" of the projected future proceeds varies inversely with the current level of interest rates. Simply put, when rates rise, the present value of a future dollar declines.
- Another reason the impact of rates is broad stems from the fact that, as I was once told by sid Cottle (of Graham, Dodd and Cottle fame), "Investing is the discipline of relative selection." That is, the attractiveness of x is in part a function of the price of y. If bonds cheapen and thus come to promise higher prospective returns, stocks (or any other asset) will appear relatively less attractive at their old prices and thus must cheapen as well in order for their prospective returns to regain competitiveness versus those of bonds.
- Further, it used to be, for example, that Americans determined the prices of U.S. stocks based on U.S. economic developments and Europeans determined the prices of European stocks based on European developments. These were local markets then, and they behaved differently. Today, investing is more globalized, and the prices of assets in different countries are determined by many of the same people, who may respond in common to fundamentals and psychology.
- The last reason many assets have moved together is that in this particular episode, many hedge funds managers (who, as we will discuss later, appear to have had a disproportionate impact on recent events) were forced by their increased capital to invest aggressively in macro-trends spanning national borders. This small group of hyper-active investors may have hooked markets up to an unusual degree.

For these reasons and others, asset prices may prove more highly interconnected than one had expected.

* * *

The most noteworthy feature of the recent correction may be the role of some prominent hedge fund managers. It was reported on February 25 that George Soros's Quantum Fund had lost \$600 million on its yen position in one day. On April 1, we read that Michael Steinhardt had lost \$1 billion of his \$5 billion under management, due largely to the drop in bond prices, and that in the last two months, investors in Askin Capital Management's Granite Funds may have lost 100% of their \$600 million capital in mortgage backed securities.

Hedge funds occupied a meaningful part of our February 17 memo because they were felt to exemplify (to a power of ten) the risk-tolerant behavior of investors in general. Thus their subsequent experience can offer us some valuable and highly magnified insights. The important observations, applicable to all investment behavior, are as follows:

- **Words alone mean very little.** Just as "portfolio insurance" turned out in the 1987 Crash not to insure much, today's startling losses indicate that many "hedge funds" don't really hedge enough to make a difference, and that the Granite Fund, which described itself as "market neutral," was anything but.
- Following from the above, we are reinforced in the belief that some investors don't know what their managers are doing, or how much risk they're taking. As one "fund of funds" which had invested in the Granite Fund told the Wall Street Journal, "It's unbelievable. This was touted as a low-risk, low-volatility, market-neutral investment. We were clearly misled." **Only by really knowing what a manager does can you be sure he is right for you,** but this often comes down to whether the manager truly understands his market, describes it accurately and does what he says he will -- things that can't be assessed from a marketing brochure.
- **Investment strategy really is a two-edged sword,** and he who lives by an aggressive strategy usually can die by it. It proved possible for investors to become too comfortable with volatility -- when it was on the upside and called "profit." Volatility is a lot less enjoyable when it turns to the downside, but it's the flip side of the same coin.
- The outcome can actually be worse than symmetrical when incentive fees are involved, as Jan Greer of William Simon & Sons points out. That's because while hedge fund managers took 20% of last year's big profits, they won't replace a like percentage of subsequent losses. Usually, due to the peculiarities of the math, if a portfolio is up 50% one year and down 33% the next, it's back to where it started. But if the manager takes a fifth of the 50% gain in year 1, a 33% decline in year 2 will leave it 7% under water.

- As an experienced corporate director told Forbes a few years ago, "I no longer expect people to do what I tell them to do; I've learned they only do what I pay them to do." But while a hedge fund manager may have his reputation and some capital at stake, as to fees he is in a heads-we-win-tails-you-lose position. For a manager who is paid a percentage of the profits on a one-year-at-a-time basis, a single year of investing aggressively enough at the right time can make him rich for life. Thus **managers should be entrusted with incentive fee arrangements only if they can truly be counted on to add significant value which is not accompanied by proportionate risk.**
- **Volatility + leverage = dynamite.** Only now do we see articles pointing out (after the fact) that if a hedge fund borrows short to buy long Treasury bonds with 6% "down," a 1% rise in the bonds' yield will wipe out 100% of the equity in the position.
- **When volatile securities have been bought on margin, sale may be forced if the investor can't come up with more capital during a decline.** This is a big part of what put the Granite Fund under. If you own securities without borrowing, you may experience a price drop -- which will hopefully prove temporary -- but you can't be put out of the game.
- One characteristic of many inefficient markets is some measure of illiquidity. Thus when sales are forced in a chaotic market -- whether by margin calls, client withdrawals or cold feet -- they can have the effect of contributing to or exacerbating the decline. Often in this environment, the manager's choices for liquidation will be limited to his highest quality and most marketable holdings. In this way, **forced sales can easily contribute to a deterioration of portfolio quality.** When the Granite Fund received margin calls, its manager could only get reasonable bids for securities which perform well when rates rise. Selling them cost the fund its hedge.

The prominent hedge funds that attracted the recent attention -- favorable in 1993 and less so this year -- are multi-billion-dollar entities which, because of their size, often invest not in the undervalued micro-situations on which their early records were built, but in macro-phenomena all around the world. Thus they provide an important object lesson to which we want to point.

These funds are run by managers who pursue aggressive returns through the use of highly leveraged and thus volatile positions in large markets, some of which, such as Treasury bonds, are relatively efficient. **In this sense, they represent the opposite of what we espouse.**

Our approach emphasizes the low-risk exploitation of inefficient markets, as opposed to aggressive investment in efficient ones. We restrict ourselves to markets where it is possible to know more than other investors. We put avoiding losses ahead of the pursuit of profits. And we do not seek to employ leverage.

Inefficient markets must by definition entail illiquidity and occasional volatility, but we feel unleveraged and expert investment in them offers investors with staying power the best route to high returns without commensurately high risk.

And we also feel investors who are capable of observing clinically can learn some valuable lessons from the current episode. We look forward to learning along with you.

April 11, 1994

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To: Clients
From: Howard Marks
Date: July 15, 1994
Subject: "How Does an Inefficient Market Get That Way?"

In an efficient market, the actions of intelligent, informed, diligent and objective investors cause assets to be priced fairly based on the available information such that their prospective returns are in proportion to their risk. No bargains are available, and the only way to increase expected return is to take on more risk.

But **in an inefficient market**, this process breaks down. The prerequisites for efficiency are not fully satisfied, and thus prices are able to diverge from what they "should" be. Some assets become overpriced and others underpriced. Profits can be earned by applying skill, not just for bearing risk. It becomes possible to consistently achieve superior risk-adjusted returns.

But how does a market get that way? There are many possible reasons. Maybe most investors ignore the market niche because it is little known. Perhaps information is skimpy or unevenly disseminated. Market infrastructure may be under-developed, so trading difficulties scare investors away. Maybe there's no trade reporting, so Seller A doesn't know what B got just a few minutes earlier and settles for less. The list of possible reasons goes on and on, but we have our own favorite: **Investors fail to act objectively and dispassionately.**

An efficient market must be unbiased. That is, the participants must be motivated just by economics and willing to either buy or sell depending on price. If every owner wants to (or must) sell a given good and won't become a buyer no matter how low the price goes, the price of that good can fall below the "fair" level and it will become possible to find bargains. Conversely, prices can go too high when everyone wants to own something . . . whether it's tulip bulbs, South Sea pearls or nifty-fifty stocks.

And that brings us to the high yield bond market which remains, in our opinion, decidedly inefficient. High yield bonds continue to offer 350-400 basis points more yield than "riskless" Treasury bonds to compensate for the risk of losing 50-150 basis points per year to credit problems. And high yield bonds have the best performance record of any major sector of the fixed income universe for virtually every period through today. One would certainly expect these facts to attract buyers and raise prices.

In 1984, I was sure this market would become efficient in five years. But it hasn't done so ten years later, despite the high historic and prospective returns. **Why haven't enough buyers stepped forward to eliminate the excessive risk premium, render these bonds fairly priced and correct the inefficiency?**

The answer, we feel, is simple: **investors continue to be unfairly prejudiced against them**. Not every investor, clearly, but enough big players to create a buyers' market and tilt the opportunity in favor of those who are willing to participate.

Prove it, you say? Well, this memo was occasioned by an article in "Pensions & Investments" reporting consultant SEI's recommendation that pension plan sponsors invest 10% to 30% of their fixed income portfolios in high yield bonds. As I went through the article, my reaction was that it was a great selling piece for our market sector -- not just SEI's recommendation, but what the article demonstrated about investor attitudes.

According to the article, SEI feels "a sponsor could add about 20 basis points of return without adding risk by putting 10% of its fixed income portfolio in high yield, or junk, bonds." And that's after SEI "tried to be as conservative as possible in its assumptions." I'm sold! But the article goes on to show how a market can be biased against an asset class:

. . . High yield is perceived as a way to add diversification, but is not well-received by clients. "Not a lot of our clients are opting to use them We work with some clients who just plain don't want them in their portfolio." (Callan)

Because of the negative publicity surrounding high yield bonds around the turn of the decade, plan sponsors either are wary of investing in them, or are afraid of being associated with them. (Pensions & Investments)

Some plan sponsors may be limited by plan guidelines to investment-grade securities, . . . Other sponsors may be wary of junk bonds because of the market's well-publicized collapse in 1989 and 1990, and the securities' association with Michael Milken and the now-defunct bond house Drexel Burnham Lambert. (SEI)

If we're going to worry about a collapse, I hope it'll be one looming ahead, not one which occurred five years ago. The asset class that collapsed in the past is likely to be cheap, not to be riding a crest of popularity and thus heading for a fall.

But too many investors drive looking in the rear-view mirror. As someone at my former place of employment once told clients, "We're buying the oils; they've been good to us." We'd rather buy what has performed badly or is the subject of negative bias and thus is cheap. We feel strongly that high yield bonds qualify today, and we'd be glad to talk more about them, or about the opportunities in other areas.

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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

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Memo To: Oaktree Clients

From: Howard Marks

Re: The Value of Predictions II (or "Give That Man a Cigar")

Date: July 22, 1996

In a February 1993 memo entitled "The Value of Predictions," I expressed my negative opinion of attempts to predict the macro-future. Now, to follow up, I've examined a handful of semi-annual Wall Street Journal economic surveys I've been stashing away. Please note that this was not a scientific study; my sample was limited to the contents of my desk drawer. The conclusions are interesting nevertheless.

First, can accurate forecasts be made? The record shows the predictions of the Journal's average "expert" to have added little value in terms of predicting the future. The table below shows the wide margin by which the consensus missed the mark.

	<u>90-day bill rate</u>	<u>30-year bond rate</u>	<u>Yen/\$</u>
December '93			
12-Month Prediction	3.7%	6.4%	115
December '94 Actual	5.7	7.9	100
December '94			
6-Month Prediction	6.5	7.9	104
June '95 Actual	5.4	6.6	85
December '94			
12-Month Prediction	6.4	7.6	107
December '95 Actual	5.1	5.9	103
June '95			
6-Month Prediction	5.4	6.6	89
December '95 Actual	5.1	5.9	103
June '95			
12-Month Prediction	5.3	6.6	92
June '96 Actual	5.2	6.9	110
December '95			
6-Month Prediction	4.9	6.0	105
June '96 Actual	5.2	6.9	110

On average, these predictions were off by 15%. **In the three sets of half-year data I had available, the average expert forecaster couldn't even get closer than 96 basis points when attempting to predict the level of long rates six months out!** And missing long rates by 96 basis points implies missing the price of the \$1000 long bond by \$120.

Second, are these forecasts of any value? My limited survey shows the average forecast published by the Journal has not been helpful. The key isn't whether the forecasters accurately predicted the **level** of the parameters but, (since you make money by anticipating change), whether they were right about the **likelihood** of significant change and its **direction**. That these forecasts weren't of value can be seen clearly in the following table, which looks at changes rather than levels.

	<u>90-day bill rate</u>	<u>30-year bond rate</u>	<u>Yen/\$</u>
December '93 12-Month			
Predicted Change	+ 60 b.p.	+ 10 b.p.	+3
Actual Change	+260 b.p.	+160 b.p.	-12
December '94 6-Month			
Predicted Change	+ 80 b.p.	--0--	+4
June '95 Actual	- 30 b.p.	-130 b.p.	-15
December '94 12-Month			
Predicted Change	+ 70 b.p.	- 30 b.p.	+7
December '95 Actual	- 60 b.p.	-200 b.p.	+3
June '95 6-Month			
Predicted Change	--0--	--0--	+4
December '95 Actual	- 30 b.p.	- 70 b.p.	+18
June '95 12-Month			
Predicted Change	- 10 b.p.	--0--	+7
June '96 Actual	- 20 b.p.	+ 30 b.p.	+25
December '95 6-Month			
Predicted Change	- 20 b.p.	+ 10 b.p.	+1
June '96 Actual	--0--	+100 b.p.	+7

As the table shows, it's not that the forecasters were always wrong; when there was little change, they were often right. It's just that in times of major changes, (when accurate forecasts would've helped one make money or avoid a loss), the forecasters completely missed them. In the years reviewed, the expert consensus failed to predict **all** of the major developments. Included here are interest rate increases of 1994 and 1996, the rate decline of 1995, and the massive gyrations of the dollar/yen relationship. In summary, there simply hasn't been much correlation between predicted changes and actual changes.

Third, where do these forecasts come from? The answer is simple: If you want to see a high correlation, take a look at the relationship between current levels and predicted future levels. The table below, which does just that, shows a remarkably better "fit."

	<u>90-day bill rate</u>	<u>30-year bond rate</u>	<u>Yen/\$</u>
December '93 Actual	3.1%	6.3%	112
12-Month Prediction	3.7	6.4	115
December '94 Actual	5.7	7.9	100
6-Month Prediction	6.5	7.9	104
December '94 Actual	5.7	7.9	100
12-Month Prediction	6.4	7.6	107
June '95 Actual	5.4	6.6	85
6-Month Prediction	5.4	6.6	89
June '95 Actual	5.4	6.6	85
12-Month Prediction	5.3	6.6	92
December '95 Actual	5.1	5.9	103
6-Month Prediction	4.9	6.0	105

Now that's a correlation! On average, the predictions were within 5% of the levels which prevailed at the time they were made. When rates were low, the experts predicted that they would stay low; after rates rose, they were expected to stay high. High dollar/yen exchange rates brought high dollar/yen forecasts, and vice versa. There's no question about it: each consensus forecast represented a near-extrapolation of then-current levels. Like many forecasters, these economists were driving with their eyes firmly fixed on the rearview mirror.

On the one occasion, in 1994, when the consensus of forecasters was bold enough to venture a prediction for short rates which differed substantially from the then-current levels, they got even the **direction** of the subsequent change wrong. The problem is that, rather than extrapolate the year-end 1994 level, they extrapolated the 1994 trend, which reversed in 1995.

In general, we can say with certainty that these forecasters were much better at telling us where things stood than where they were going. This bears out the old adage that **"it's difficult to make accurate predictions, especially with regard to the future."** The corollary is also true: predicting the past is a snap.

And using the prevailing levels to predict the future would have been just about as effective as the average forecast. The prevailing levels differed from the future levels by 16% on average, while the consensus prediction erred by 15%.

Fourth, can't anyone get it right? It is absolutely not true that nobody makes accurate forecasts. Every six months, when the Journal reports on a new survey of forecasts, it takes the opportunity to cite the forecaster in the previous survey who came closest to accurately predicting the three financial indicators shown above plus the change in GNP and CPI. It prints the winner's picture and lauds the unique insights which led to the accurate forecasts.

And the truth is that the winner's accuracy is often startling, as shown in the following table with regard to what we consider the most important of the indicators, the interest rate on the 30-year Treasury bond. Each time, the winner's forecast was quite close to the actual and much more accurate than the consensus.

	Susan Sterne Economic Anal. Assoc. <u>December 1994</u>	James Smith Univ. of No. Caro. <u>June 1995</u>	Michael Cosgrove The Econoclast <u>December 1995</u>
Winner's Prediction	6.80%	6.05%	6.90%
Subsequent Actual	6.62	5.94	6.89
Consensus Prediction	7.92	6.60	6.00

Looking at the winning forecasters' results shown above, one might even be tempted to conclude that accurate predictions are in fact achievable.

Fifth, then why do I remain so negative on forecasters' ability? The important thing isn't getting it right once. It's doing so consistently.

The table below shows two things that might make you think twice about heeding the winners' forecasts. First, they generally failed to make accurate predictions in surveys other than the one they won (shown in bold). And second, in the surveys they didn't win, their forecasts were much more wrong than even the inaccurate consensus half the time.

	<u>December 1994</u>	<u>June 1995</u>	<u>December 1995</u>
Susan Sterne	6.80%	6.00%	5.00%
James Smith	7.40	6.05	5.55
Michael Cosgrove	7.50	7.70	6.90
Consensus Prediction	7.92	6.60	6.00
Subsequent Actual	6.62	5.94	6.89

As the Journal itself pointed out in reviewing the results of the December 1995 survey:

. . . by giving up the comfort of the consensus, those on the fringes of the economic prediction game often end up on the winning or losing end. James Smith of the University of North Carolina and Susan Sterne of Economic Analysis Associates, the winners six months and one year ago, respectively, **didn't even get the direction of interest rates right this time.** The same happened last year to

Wayne Angell of Bear, Stearns Securities Corp., the winner before them
(Emphasis added)

An interesting pattern emerges from the data shown above. In all three surveys, Ms. Sterne's prediction was the lowest of the three experts and Mr. Cosgrove's was the highest. One way to get to be right is to always be bullish or always be bearish -- if you hold a fixed view long enough, you may be right sooner or later. And if you're always an outlier, you're likely to eventually be applauded for an extremely unconventional forecast that correctly foresaw what no one else did. But that doesn't mean your forecasts are regularly of any value.

A lot of adages fit this data. I've heard it said that "even a blind squirrel occasionally finds an acorn," "a stopped clock is right twice every day" and "if you put enough monkeys in a room with typewriters, eventually one of them will write the Bible."

I feel the sum of this data shows that it's possible to be right about the macro-future once in a while, but not on a regular basis. It doesn't do any good to possess a survey of 64 forecasts that includes a few which are accurate; you have to know which ones they are. And if the accurate forecasts each six months are made by different economists, it's hard to believe there's much value in the collective forecasts.

By the way, there's an important analogy to be drawn here: Efficient market advocates don't say it's impossible to beat the market; lots of people do it every year. (Remember, half the observations in any sample are above the median.) They only assert that no one can consistently do so in risk-adjusted terms.

Finally, can macro-forecasts be used to gain an advantage? I pointed out in my 1993 memo that most of the time, you can't get superior results with inaccurate forecasts **or** with accurate forecasts that reflect the consensus. (This is because the consensus view of the future is already embedded in the price of an asset at the time you buy it). To bring above average profits, a forecast generally must be different from the consensus **and** accurate.

But, as I described in 1993, it's difficult with regard to a non-consensus view of the future (1) to believe in it, (2) to act on it, (3) to stand by it if the early going suggests it's wrong, and (4) to be right. Those who invest based on fringe predictions are often wrong to an embarrassing and costly extent.

At Oaktree, we don't spend our time attempting to guess at the future direction of economies, rates and markets, things about which no one seems to know more than anyone else. Rather, we devote ourselves to specialized research in market niches which others find uninteresting, unseemly, overly complicated, beyond their competence or not worth the effort and risk. These are the inefficient markets in which it is possible to gain a "knowledge advantage" through the expenditure of time and effort. They also happen to be markets in which micro factors relating to companies, assets and securities matter the most. This is where it's possible to find bargains, and only bargain purchases can be counted on to dependably lead to returns which are above-average relative to the risk entailed. We say "**we try to know the knowable**" -- **and that doesn't include the macro-future.**

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Memo to: Oaktree Clients and Friends
From: Howard Marks
Re: Will It Be Different This Time?

One of my favorite articles, "Why This Market Cycle Isn't Different" by Anise C. Wallace, appeared in the New York Times. It skeptically recounted the rationale being advanced why a traditional correction of the stock market's meteoric rise need not take place. Among the reasons cited were (1) the outlook for continued economic growth, given that the economy had learned how to correct itself painlessly, (2) hope for return to a gold standard, (3) optimism regarding world peace, (4) the likelihood of continued buying of U.S. stocks by foreign investors piling up dollars with no better place to go, and (5) the fact that stocks were not overvalued compared to other assets, which had also appreciated.

This was the optimists' argument. But its flaws became apparent almost immediately after the article was published ... **on October 11, 1987**. By the close on October 19, the market had fallen by 30%. So much for the bulls' predictions!!

And so much for predicting a future markedly different from the past. The article pointed out that some of the arguments did have some truth to them, but it also cited John Templeton's assessment that people who say things will be different are right only one time out of five. The hard part is knowing which times those are.

All of this was called to mind ten days ago by an article on the front page of the Wall Street Journal. Entitled "The Business Cycle is Tamed, Many Say, Alarming Others," it recounts the case currently being made for this remaining a continuous, recession-free economic expansion. As its lead paragraph says,

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.

The current expansion, at 67 months, has already far exceeded the postwar average. Nevertheless, 51 of the 53 "top economists" surveyed by Blue Chip newsletter (my favorite experts and the subject of my July 22, 1996 memo) predict growth next year of 1.5% or more. And the University of Michigan survey finds that among consumers, more expect five more good years than expect bad times to emerge.

The Chairman of Sears states "There is no natural law that says we have to have a recession." According to Amoco's Chairman, "I don't see any reason to believe [the recovery] can't go on until the turn of the century." Sara Lee's CEO says "I don't know what could happen to make a cyclical downturn." (For a few more quotes like these, see page three.)

The article goes on to cite the arguments behind this year's version of "this time it'll be different." First, because the recovery has been wishy-washy to date, there is no "boom" to "bust." Second, today's enhanced pace of business has been accommodated more through flexibility and efficiency than through brick-and-mortar expansion and inventory building. Third, the service economy has largely supplanted the more cyclical manufacturing sector. Fourth, globalization of the economy will enhance geographic diversification and provide new sources of demand for goods.

Similarly, we all hear lots of reasons why today's high stock market valuations aren't dangerous and no correction is required. These include the inevitability of 401(k) inflows; the steadfastness of mutual fund investors; the shortage of stocks which will result from corporate buybacks (in 1987, the shortage was going to result from the privatization of companies via leveraged buyouts); the vast opportunities presented by technology and the Internet; the improved profit stance of business after years of downsizing and cost-cutting; the fiscal responsibility imposed on government and the resulting favorable outlook for the deficit; and the irrelevance of dividend yield and other traditional valuation parameters. As always, the list appears to grow longer as higher levels are reached on the Dow.

But I recoil any time I hear a prediction that trees will grow to the sky, or that centuries of history are irrelevant. When I hear people say the valuation measures of the past no longer matter, I think John Kenneth Galbraith put it well, stating that in a speculative episode,

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. (*A Short History of Financial Euphoria*, Viking, 1990)

And I feel cyclicity is one of the few constants in the economy and markets. Cycles are the result of human behavior, herd instinct and the tendency to psychological excesses, and these things are unlikely to evaporate. Galbraith cites "the extreme brevity of the financial memory" in explaining why markets are able to move to extremes of euphoria and panic. And few adages have been borne out as often as "What the wise man does in the beginning, the fool does in the end." It is rare for trends to be curtailed at a reasonable point before swinging to the excesses from which they invariably correct.

Today, there are some signs just as worrisome as the bullish arguments are constructive. We detect the decline of skepticism and discipline and the aggressive extension of credit which regularly precede corrections. Capacity expansion has been strong in some industries, and construction seems about to resume. Consumer debt, default and bankruptcy are all at high levels. Prices being paid in acquisitions are once again high. There's too much money chasing too few deals. The stock market is exhibiting unusually narrow "breadth" (e.g., with the Dow up 76 points today to 6547, another record, half of all stocks were unchanged or down). Every cocktail party guest and cab driver just wants to talk about hot stocks and funds.

And there's a final factor I want to mention: capitulation. This is the word I use to describe investor behavior late in cycles. Investors hold to their convictions as long as they can, but when the economic and psychological pressures become irresistible, they surrender and jump

on the bandwagon. Given years of above-average performance by stocks, many investors are now increasing their commitments to equities. A few weeks ago, we learned of an extreme example, a foundation whose long-term 80% allocation to bonds had been shown to be sorely out of step, so it threw in the towel and went **100% to equities**. Capitulation like this adds to the strength of the trend (for a while), but it also increases the level of danger. First, it indicates the advanced age of the cycle; second, it can cause investors to take positions for which they are unsuited; and third, when the last investor has taken his or her maximum equity position, who's left to power a subsequent rise?

As you know, we don't consider ourselves good macro-forecasters (or even people who believe in forecasting). So we certainly are in no position to say when the recession or market pullback will start, how bad it will be...or even that there definitely will be one. But we think we're unlikely to be proved wrong if we say cyclicalities are not at an end but rather are endemic to all markets, and that every up leg will be followed by a down leg.

In 1988, when we marketed our first distressed debt fund, the greatest obstacle we faced was a somewhat widespread belief that there would be no recession and we'd have nothing to do. The theory then was that because of "rolling corrections" of individual industries and regions, the entire economy would never again decline all at once. The Times's 1987 article said that according to some investors, "the prolonged slow-growth environment would not necessarily be followed by a recession." But, of course, a recession did develop in 1990 (one of the worst since the Depression), we got very busy in distressed debt, and that 1988 fund produced a gross return of 29% per year.

So we conclude that most of the time, the future will look a lot like the past, with both up cycles and down cycles. There is a right time to argue that things will be better, and that's when the market is on its backside and everyone else is selling things at giveaway prices. It's dangerous when the market's at record levels to reach for a positive rationalization that has never held true in the past. But it's been done before, and it'll be done again.

"There will be no interruption of our present prosperity."¹

"I cannot help but raise a dissenting voice to the statements that ... prosperity in this country must necessarily diminish and recede in the future."²

"We are only at the beginning of a period that will go down in history as the golden age."³

"The fundamental business of the country ... is on a sound and prosperous basis."⁴

¹ Myron E. Forbes, President, Pierce Arrow Motor Car Co., January 1, 1928

² E.H.H. Simmons, President, New York Stock Exchange, January 12, 1928

³ Irving T. Bush, President, Bush Terminal Co., November 15, 1928

⁴ President Herbert Hoover, October 25, 1929

source: Oh Yeah?, Viking Press, 1932

* * *

In the interest of full disclosure, I want to mention here that I've been contemplating the possibility that my views on these matters are too cautious and short-sighted. My conclusion is that I am a product of my experience.

Many of us were raised by parents whose views were heavily influenced by living through the Depression. Likewise, I was baptized under fire during my first five years in the investment industry, when the shares of the best companies in America -- the "nifty-fifty" -- dropped 70% to 90% in the early 1970s and then the entire market lost roughly half its value in 1973-74.

You have to be more than forty-five years old to have been in the business during that last real bear market in 1973-74. I've heard it said that today "everyone over forty is terrified by the market, but most of the people running money are under forty." There's a lot of truth to this, and it's interesting to note that relatively few of today's investment professionals are in their mid-to-late forties, a scarcity caused by the tough times in the industry in the 1970s and the resultant lack of hiring.

Maybe I spend too much of my time worrying about the next bear market; I've been conditioned to do that. And maybe I'm wrong. But Oaktree's clients needn't worry that we'll manage their portfolios based on the assumption that a correction is imminent. We believe strongly that "it's one thing to have an opinion but quite another thing to act as if it's right." So while we take some defensive steps in portfolios as our caution grows, we're always fully invested and just as ready for a market rise as we are for a decline.

The bottom line for us is that **if Oaktree can continue to match and beat the indices in our inefficient markets despite an overlay of protection against risk that could prove unneeded, I think we're adding real value.** That has been our history, and it certainly remains our goal.

November 25, 1996

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Memo to: Oaktree Clients and Friends

From: Howard Marks

Re: Who Knew?

For years, I've railed against people who claim they know what the future holds. And yet, in my last memo on September 3, 1997, I may actually have made a correct prediction, as follows:

What could cause a market decline? A drop in investor confidence -- perhaps the commodity that's most freely available today -- would likely be the key, but the reason is hard to foresee.... The next surprise might be geopolitical (oil embargo, war in Korea), economic (tight money, slowing profit growth) or internal to the market (competition from bonds at higher interest rates, discovery of a fraud), but it's most likely to be something that no one has anticipated -- including us.

Just the next month, the "Asian meltdown" came into full bloom, with profound ramifications for stock and bond markets all around the world.

What this shows is that it's easy to be right about the future . . . if you restrict your predictions to two: (1) something significant is bound to happen eventually, and (2) we never know what it'll be.

* * *

Speaking of what we can know, I was in a client's office in December, cautioning that I thought we would never reside for long in the investment nirvana of the new paradigm where inflation, interest rates, economic growth, expanding profits and rising stock prices stay properly aligned. He said, "I'd think a self-professed non-forecaster like you would never say, 'never'."

My response was, "Maybe it's a result of my sobering experience in the 1970s, but there are plenty of things I'll say "never" to ... on the negative side: Things will **never** go right forever. Investors' fondest hopes will **never** fail to be dashed eventually. Some unpleasant surprises will **never** fail to arise."

This sounds terribly negative, as if I think good things are rare and only bad things are bound to happen. But if you think it over, I hope you'll conclude I'm not what our Kevin Clayton calls a "Negative Ned."

I read decades ago that every bull market has three stages:

The first, when a few far-sighted people begin to believe that some improvement is possible,

the second, when most investors come to agree that improvement is actually underway, and

the third, when everyone believes everything will get better forever.

If you're going to succeed at all in timing cycles, the only possible way is to act as a contrarian: catch some opportunities at the bottom, let your optimism abate as prices rise, and hold relatively few exposed positions when the top is reached. To find bargains at the bottom, you don't have to think that things will get better forever; you just have to remember that every cycle will turn up eventually, and that prices are lowest when it looks like it won't. But it's just as important to avoid holding at (and past) the top, and the key is not to succumb to the popular delusion that "trees will grow to the sky."

What I think is important is that, although markets can be underpriced or overpriced and yet go on for months or years to become even more so, **it's most prudent to be optimistic when no one else is, and it can be highly profitable. But it can be dangerous to be optimistic when everyone else is, and very costly.**

* * *

All of the above might be interesting, but of course the crucial question is "Where do we stand today?"

Certainly, the secret's out: something bad can happen -- and has. We see Asian currencies, economies and perhaps social orders in free-fall. But what strikes me is the fact that the major U.S. equity indices are just about where they were when I wrote in September. Our market justifiably benefits from a flight to quality, and it is true that many of our companies may not be directly affected by the Asian turmoil. **But are the people pricing stocks near all-time highs too optimistic, too pessimistic, or just right?**

What amazes me is that even though people say "the market abhors uncertainty," it has been doing rather well despite the large number of things that no one can pretend to fully understand.

1) How bad will the Asian crisis get, how far will it spread, what solution is possible, and what will be the second- and third-order ramifications on our economy and companies? Will governments topple? Will contracts be abrogated? How many people who are sanguine about U.S. equities today can answer these questions concerning Asia (and how can you be the former if you can't do the latter)?

2) Most accounts of the developments in Asia touch on overcapacity, on stiffened competition from Asian exporters whose prices are now lower in dollar terms because of devaluations, and on the possibility of deflation in the U.S. Even Chairman Greenspan thought enough of deflation to mention it last Saturday. And yet, who really knows what these things might mean for economies and companies around the world? In short, is deflation good or bad? How can you feel comfortable if you can't answer these questions?

3) A reading of the newspapers in the last few months discloses a steady drumbeat of earnings disappointments and revived restructurings and layoffs. How strong is our economy? Are cost increases putting pressure on profits? How much will earnings growth slow down?

These are all questions that indicate that negatives are present in our investment environment. But they're always there -- sometimes obvious and sometimes not.

Prices near highs and optimism in bloom -- that's a dangerous combination, especially with perceived risk on the rise. Peter Bernstein wrote around 1979 that "The great buying opportunities ... are never made by investors whose happiest hopes are daily being realized." And yet many of today's investors have only known success, and few appear seriously chastened by recent developments. This permits me to conclude that **this is not a buying opportunity and, although no collapse need be imminent, the stock market's best days are behind it for a while.**

Or as our client, Mike Herman, wrote in the annual report of the Kaufman Foundation, the Investment Committee of which he chairs: "It truly doesn't get much better than this -- a statement which in and of itself should inspire caution, not complacency. If things can't get much better, logic suggests they can only stay the same or get worse."

My bottom line is that while the best bargains are found when it looks like things can't get better, bargains are hard to find when things can only get worse -- especially if few people seem to know it. That's why Oaktree always tries to keep in mind where we stand, to buy avidly only when fear is at a high level, and to utilize asset classes, strategies and tactics that prepare us for the negatives that are always lurking out there somewhere.

January 8, 1998
DJIA = 7,802

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Memo to: Oaktree Clients and Friends

From: Howard Marks

Re: Genius Isn't Enough (and Other Lessons from Long-Term Capital Management)

On September 24, The Wall Street Journal carried an excellent front-page article regarding the inability of the "crack team" of economic policy makers led by Messrs. Rubin and Summers to halt the slide of the emerging markets' economies and currencies. Heading the column was a quotation from David Halberstam's account of the U.S. involvement in Vietnam, The Best and The Brightest:

If there was ever anything that bound men ... together, it was the belief that sheer intelligence and rationality could answer and solve everything.

Across the page -- just a few columns away -- was another excellent article, this time on the subject of Long-Term Capital Management. I think the Halberstam quotation is just as relevant to this one.

The saga of Long-Term Capital is well known by now. My purpose here is not to discuss the facts, although I'll do so briefly, but rather the lessons to be learned. Long-Term was the creation of former Salomon Brothers vice chairman John Meriwether, along with several other well-respected ex-Salomon Partners, a former vice chairman of the Federal Reserve, and a pair of Nobel prize winners. It was formed to engage in bond arbitrage, the systematic exploitation of bond mispricings. By purchasing undervalued bonds and selling short overvalued bonds affected by similar factors, gains would be earned consistently and without exposure to market risk. The intellect and accomplishments of Long-Term's managers, and its strong annual returns, compelled investors to invest and freed them from feeling they had to understand exactly what the fund did. The fund's approach may not have been fully delineated to investors, its portfolio was never disclosed, and the managers' actions were not even reported after the fact; 40% annual returns were enough to keep investors satisfied.

You've probably heard us say that bond investing is a game of inches. So then how was Long-Term able to earn returns of 40% or more most years? The answer was leverage: they borrowed enough money to buy bonds worth many times their equity. It is now known that Long-Term's general partners' cash equity was increased through borrowings to roughly \$1.5 billion and paired with \$3.1 billion of limited partners' capital. This \$4.6 billion of equity was somehow sufficient to enable Long-Term to hold investments totaling about \$150 billion and long and short positions in derivatives believed to have had an aggregate "notional value" of \$1.25 trillion!

When your investments so greatly exceed your equity, it doesn't take a big drop in security prices to wipe out that equity. Between August 1 and late September, price declines on all bonds other than Treasuries, appreciation on Treasury bonds (which Long-Term had shorted to offset its exposure to interest rates on "long" positions), and declines on equities (it had invested heavily in takeover stocks) were sufficient to erase 90% of Long-Term's equity. Further, if margin calls had caused its vast positions to be dumped on the world's unsteady markets, the proceeds might have been less than the amounts borrowed, causing write-offs at the banks and brokers that had provided Long-Term's credit and perhaps destabilizing them. Incredibly, articles about Long-Term describe its possible forced liquidation with phrases like "threat to the stability of the world financial system ... " (The Wall Street Journal, September 29). These conditions gave rise to the restructuring and additional investment agreed to by 14 financial institutions. That's the background; now for the lessons.

The techniques employed at Long-Term have been variously described as "rocket science" or "black box." Computers were used to scan thousands of securities to detect instances where historic relationships had been violated and profit could be earned on the return to the norm; these are referred to as "convergence trades." Assumedly, Long-Term used models to assess the probability of history reasserting itself and the risk to the overall portfolio of individual relationships going the wrong way. Thus would they determine the amount of risk and leverage that could safely be taken on.

In his wonderful book, Against the Gods, Peter Bernstein shows how development of the study of probability made possible both informed gambling and informed investing (along with other forms of decision making concerning the future). But the products of this pursuit remain mere probabilities, or reasonable expectations. Likely events sometimes fail to occur, and unlikely events sometimes do. Or, as my friend Bruce Newberg says when I get the one improbable roll of the dice needed to beat him in backgammon, "there can be a big difference between probability and outcome." If you are conscious of the difference between a likely outcome and a certain one, you may not want to bet the ranch.

The same is true in the world of investments; put simply, relationships that are supposed to hold sometimes fail to do so. This may happen because markets and systems don't work (in the Crash of 1987, portfolio insurers couldn't get their stop-loss sales off), because external events aren't fully anticipated (inverse floaters tanked in 1994 because interest rates rose at annual rates of 600 or 700 basis points that had been considered impossible), or simply because of the unreliability of the human participants (scared people often fail to step forward with cash at the times that matter most). A relationship's failure to hold often comes just when faith in it has reached an excessive level and huge sums have been bet on it. **For whatever reason, we have seen many instances when probabilistic models turned out not to have made sufficient allowance for an "improbable disaster."**

As Long-Term's Meriwether wrote in his September 2 letter to investors, "the Fund added to its positions in anticipation of convergence, yet ... the trades diverged dramatically." In other words, sometimes things that are cheap just get cheaper and things that are dear get dearer.

For free markets to operate at equilibrium, there must be healthy tension between two motivating factors: fear and greed. If a participant feels both, greed will push him to take chances but fear will put limits on the risk he assumes. However, the two are not always in balance -- one or the other is often in the ascendancy. For the last few years, too little fear has been present, and greed and risk-taking have dominated. Long-Term's managers' brainpower may have let them consider their process foolproof, so that they felt too little fear and took on too much risk. In every era, one prominent participant becomes emblematic, and Long-Term is likely to be known for a long time as the "poster boy" of the 1990s.

I think investors are always looking for "the silver bullet." They seek a course of action that will lead to large profits without risk -- and thus they pursued Nifty-Fifty investing in the 1970s, portfolio insurance in the '80s and market-neutral strategies in the '90s. Often, they align themselves with "geniuses" who they hope will make it easy for them -- be it Joe Granville, Elaine Garzarelli, David Askin or John Meriwether.

But the silver bullet doesn't exist. No strategy can produce high rates of return without some risk. And nobody has all of the answers; we're all just human. **Brilliance, like pride, often goes before the fall.** Not only is it insufficient to enable those possessing it to control the future, but awe of it can cause people to follow without asking the questions they should and without reserving enough for the rainy day that inevitably comes. This is probably the greatest lesson of Long-Term Capital Management. There are others, which I'll review below.

1) As I've written before, **"volatility + leverage = dynamite."** The main cause of Long-Term's collapse probably wasn't its security selection, or the declines in its markets, but rather its leverage. On average, its positions may have declined just a few percent. But when your assets exceed 25 times your equity, even a 4% price decline is enough to wipe you out.

Nowadays, most people use the word "leverage" interchangeably with "debt." But it's better understood in the sense I first learned: the extent to which a change in the top line is magnified by the time it reaches the bottom line. That's why the British call it "gearing." In Las Vegas they say "the more you bet, the more you win when you win." They never add "... and the more you lose when you lose." Leverage is just a way to let you bet more than your capital, and it exposes you to more of the good and more of the bad. Leverage can truly be dynamite.

None of Oaktree's portfolios use leverage to invest more than our capital (although our Emerging Markets Fund will be able to do so to a limited extent). We have reviewed several opportunities for leverage, but in the risk-tolerant climate prevailing until recently, we didn't find base returns worth leveraging up. For example, despite repeatedly being invited to do so over the last five years, we declined to organize CBOs (leveraged high yield bond portfolios). This followed from our conviction that **leverage should never be used in an attempt to turn low spreads into wide ones, only to take advantage of already-wide spreads.** The managers of Long-Term used enormous leverage in an attempt to profit hugely from minute spreads, and it eventually did them in.

2) **Hedge funds offer no magic per se.** As we described in our April piece on alternative investments, hedge funds carry only two common threads: private partnership status and a fee mechanism through which general partners share in net gains. The hedge fund investor's birthright certainly does not include either high returns or low risk.

But the hedge fund structure can have ramifications which investors (such as Long-Term's) seem to recognize only after problems arise. Our memo entitled "Risk In Today's Markets" (February 17, 1994) asked the following about 'til-then successful hedge funds:

With the average stock or bond returning 10-15% last year, how did some hedge funds make 70% or more? It was through bold and heavily-leveraged plays ... What would have happened if the managers' calculations had proved wrong? ... Do the hedge fund aficionados know how much risk they are taking? For how long are they tying up their money? How much do they know about the strategies being employed?

We never hope that our warnings will turn out to be needed, but we usually feel it is inevitable. The case of Long-Term demonstrates that hedge funds represent no panacea and often hold significant drawbacks. The closed-end structure should be entered into only after the underlying strategy has been reviewed in depth and confidence in the managers has been fully justified.

3) **"If it seems too good to be true, it probably is."** This old saw goes out of style from time to time, but it makes a comeback each time a get-rich-quick scheme is exposed. Many "riskless" arbitrage, hedge and market-neutral strategies have turned out to involve more risk than was let on.

When I was a kid, I saw in a 1930s movie that the Rothschilds built their fortune because their exclusive use of carrier pigeons allowed them to simultaneously buy a currency at one rate in London and sell it at a different rate in Paris. That's pure arbitrage: trading the same asset at different prices at the same time.

But as soon as you deal in different assets that have less than a 100% probability of moving in tandem, you introduce "basis risk," or the risk that the assets being arbitrated won't go in the anticipated directions. That's what killed Long-Term; their bonds' yields diverged when they were supposed to converge. Historic relationships proved to be less dependable than had been thought.

4) **"It's always something."** That's what Roseanne Rosanadana used to say on Saturday Night Live, and it's very true -- eventually, something always goes awry. Any course of action which depends on everything going right is unsafe, but such an expectation has to have been behind Long-Term's 25-plus times leverage. Warren Buffet, with his insistence on "margin for error," would never make such a bet (although he was willing in the hours just before the restructuring to join Goldman Sachs and AIG in a low-ball bid of \$250 million for Long-Term at a time when its net worth is thought to have been \$600 million).

In "Are You an Investor or a Speculator" (September 3, 1997), we wrote:

What could cause a market decline? A drop in investor confidence -- perhaps the commodity that's most freely available today -- would likely be the key, but the reason is hard to foresee. **"We're not expecting any surprises,"** people say, and that has become our new favorite oxymoron. Surprises are never expected -- by definition -- and yet they're what move the market....The next surprise could be geo-political (oil embargo, war in Korea), economic (tight money, slowing profit growth), or internal to the market (competition from bonds at higher interest rates, discovery of a fraud), but it's most likely to be something that no one has anticipated -- including us.

When I was a kid, my dad used to joke about the habitual gambler who finally heard about a race with only one horse in it. He bet the rent money on it, but he lost when the horse jumped over the fence and ran away. **There is no sure thing**, only better and worse bets, and anyone who invests without expecting something to go wrong is playing the most dangerous game around.

5) **"Never confuse brains with a bull market."** When the 1990s began, the economy and the stock market were at very low levels. As a result, success came easily, risk-bearing paid off and the highest returns often went to those who took the most risk. They and their strategies were accepted as the best.

In my opinion, (a) the three ingredients behind success are timing, aggressiveness and skill, and (b) if you have enough aggressiveness at the right time, you don't need that much skill. But those who have attained their success primarily through well-timed aggressiveness can't be depended on to repeat it -- especially in tough times. When an investment track record is considered, it's essential that the relative roles of these three factors be assessed.

6) **Change in the availability of credit is a powerful force**, and the longer I'm in the investment business, the more I respect the role of the credit cycle. For example, although we hope we added value through our implementation, our 1990 distressed debt funds earned their 50% gross returns largely because (a) fear and the government's actions closed the credit window, (b) the LBOs of the 1980s couldn't refinance their debt and defaulted in droves, and (c) that debt could therefore be bought for a song. A significant recession contributed to the conflagration, but whereas a generous capital market would have let companies finance their way out of trouble (as they did from 1993 through mid-1998), a tight one brought them down in 1990-92.

The product of lenders is money, and it's their job to move it off the shelves. Because money is the ultimate undifferentiable commodity, lenders can compete for market share in boom times only by taking on bigger risks than the next guy, charging less interest or accepting looser terms. All of these tactics turn on a dime when things get tough, inflicting great pain and causing lending to contract.

In times of easy money, companies prosper that should not, just as deserving companies fail when money's tight. Easy money was key in Long-Term's early success and later collapse. The bankers and brokers let the General Partners lever up their equity capital and take on far out-sized positions. They loaned amounts of money that were unsafe both for Long-Term Capital and for themselves. I assume that, seduced by Long-Term's brilliance, they did so without knowing how much it had borrowed in total or what its portfolio looked like.

The violent swings of the credit cycle -- usually far more volatile than the underlying economy -- are behind many of the extreme occurrences in the business and investment world. Excessive lending contributed greatly to booms preceding the collapses in real estate in 1989-92 and emerging markets in 1997-98, just as tight lending added to the bankruptcies of 1990-92. Look around the next time there's a crisis; you'll probably find a lender.

7) **“How Quickly They Forget.”** While it would be great (and very profitable) to be able to see the future, the truth is that few of us can. But you don't have to be prescient to be able to invest intelligently while avoiding the most dangerous hazards. Knowledge of the past will get you a good part of the way there.

The relevance of the lessons of Long-Term has nothing to do with knowledge of the future. Leverage is always dangerous. Something always goes wrong eventually. Those who see high returns often mistake risk bearing for genius. The swings of the credit cycle can overwhelm all other factors. Every boom carries within itself the seeds of decline (just as every bust lays the groundwork for recovery). Forget forecasting -- you'll be well ahead if you simply bear in mind the lessons of the past.

We've all heard George Santayana's famous observation that "Those who cannot remember the past are condemned to repeat it." And yet, how many of today's mistakes are just replays of the past? Thirty years ago, the stocks of "the best companies" reached P/Es of fifty and more from which they eventually collapsed. Ten years ago, highly leveraged investments were financed with bridge loans which investment bankers were stuck with when the financing window closed. Five years ago, banks got into big trouble with derivatives. All of these are causing problems again in 1998 for those who forgot history or rationalized its irrelevance in the "new paradigm."

I've previously recommended John Kenneth Galbraith's excellent little book, [A Short History of Financial Euphoria](#). Although I don't appreciate its swipes at high yield bonds, I consider it must reading for anyone who wants to think and invest against the grain. Galbraith says:

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. [Emphasis added]

Amen. People who acknowledge no limits on their ability to know and control the future have no need to study history. For the rest of us, it's one of the best tools we've got.

* * *

Inability to remember that you can't know what the future holds is a common failing and the cause of some of the biggest financial difficulties. It's one of the greatest contributors to hubris -- the over-estimation of what you can know and do.

General Motors's Charles Froland says the people of Long-Term Credit developed "too much conviction." Henry Kaufman was recently quoted on the subject as saying "there are two kinds of people who lose money: those who know nothing and those who know everything." Dirty Harry weighed in, saying "a man has to know his limitations." I actually think my mother had it best: "He who knows not and knows not he knows not is a fool; shun him."

Oaktree is built on the following axioms (among many others):

- We can't know everything about the future, and the "bigger picture" the question, the less we can know the answer.
- We must always expect that something will go wrong and build in margin for error.
- When the market embodies too much greed, we must be conscious of the risk that's present. When it swings too far toward fear, we should take advantage of the bargains that result.
- We must constantly remind ourselves of our limitations and dedicate ourselves to the avoidance of hubris. If our methodologies are valid and our people are talented, hubris is one of the few things that could make us fail.

The applicability of the lessons of Long-Term is not limited to that company alone. Instead, they illustrate several of the universal truths in investing. You won't see them forgotten here.

October 9, 1998

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Memo to: Oaktree Clients
From: Howard Marks
Re: How's the Market?

April 5 was just another ordinary day in the market, with big gains achieved and records broken. The Wall Street Journal article about it on April 6 was ordinary too, like hundreds that have been written in this bull market. I was struck, though, by the way it told in just a few paragraphs the whole story of what's been going on.

Just another day - On the surface, the aggregate stock market numbers continued to be very positive, with the Dow up 175 points, or 1.8%, to a new record. The S&P 500 was up 2.1% and the Nasdaq Composite Index was up 2.7%.

Even on this day of huge aggregate gains, however, participation was still relatively narrow. Almost as many stocks were down (1,318) as up (1,695). Moreover, more stocks set new 52-week lows (81) than set new highs (73).

This reminded me about the reliance of the market on just a few issues: In the first quarter of this year, 18 stocks accounted for all of the 5% rise in the S&P 500, (that's right, the other 482 stocks averaged a zero return). 55% of the stocks in the S&P lost money, and the Russell 2000 index of second tier stocks declined 5.4%.

Follow the leader -- So the leadership continued to be concentrated, as everyone knows, in just a few stocks. Yahoo gained 22% on the day, and Amazon.com was up 9%. Although IBM rose 4%, it was overshadowed by America Online, which gained 11% and became the more valuable of the two companies for the first time.

Illustrating the mania for things Internet, an article in the next day's New York Times reported on . . .

. . . last week's initial offering of Priceline.com, which allows customers to name their own price for airline tickets on the Web. After less than a year in business, during which it lost \$114 million selling \$35 million worth of tickets, Priceline.com is valued at \$10 billion, more than the combined net worth of UAL's United Airlines, Northwest Airlines and Continental Airlines.

Indifference to valuation - The entire bullish article - 22 column inches long - omitted all mention of valuation parameters such as P/E ratio, EBITDA multiple or dividend yield. The bottom line is that many of the investors setting the prices in today's market don't care about valuation. I get no sense at all that the analysts and portfolio managers

backing the large-cap growth stocks and Internet high flyers can imagine prices at which they would be mere "holds" or (heaven forbid) "sells."

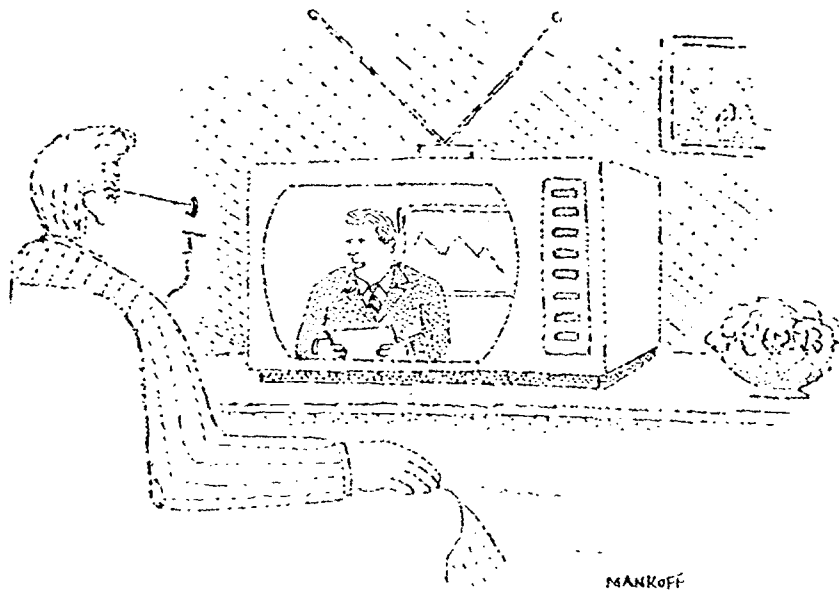
Looking on the bright side - The bulls - who are firmly in control - have joined with the media to interpret things in a positive light. I got a chuckle out of the article's description of investor reaction to the jobs data released on April 2:

Those showed low unemployment, which was good for consumer spending; low wage increases, which implies weak inflation; and mild job creation, which implies a growing but not overheating economy.

I'm sure that in other times and climes, it would have come out this way instead:

Those showed low unemployment, which carries a threat of renewed inflation; low wage increases, which implies an anemic economy; and mild job creation, which presages weak consumer spending.

Of course, economic developments are always subject to varying interpretation. The above passage sent me to the archives for one of the absolute classic cartoons:



"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."

*Drawing by Mankoff: @ 1981
The New Yorker Magazine, Inc.*

Something for everyone (but little genuine debate) -- As the article reported,

Wells Capital last week urged clients to move money into stocks from bonds, shifting holdings to 70% stocks and 30% bonds, from 65% and 35% . . .

Taking the opposite approach to Wells Capital, . . . Bear Stearns urged clients to cut their stock exposure to 55% from 60% of their portfolio, moving the money into short-term cash accounts.

As for me, I'm certain one of them will be proved right.

Weak underpinnings - The article reflected the bulls' preoccupation with things that either don't really matter in any fundamental sense . . .

. . . people are buying cars, they are buying houses, they are spending money. . . I think the wind is still at the market's back.

. . . or say absolutely nothing about long-term value:

The whisper today was that the online firms are going to have very strong earnings.

Gobbledegook -- Lastly, some of what's going on just makes no sense at all.

People are very comfortable that the earnings projections are going to be hit, but the expectations are higher than that.

I have no idea what that means, but I'm sure it'll be good for a few hundred points on the indices.

* * *

Lots of sound and fury, signifying nothing. There's a lot said, in the article I'm writing about and in the media generally, but not a lot of insight. And a lot of money being made, but most of it by the few most optimistic and aggressive investors.

The "rational" value investors have been decrying the excesses of the market for years – myself included. I've never felt more strongly the truth of the saying I picked up in the 1970s: "being too far ahead of your time is indistinguishable from being wrong." But as they say, "that's my story and I'm stickin' with it."

April 15, 1999

P.s.: Another Journal story on April 9 was equally illustrative of the times, but with regard to the flip side. Rather than describe the great success of the few on-line stocks, it recounted the tribulations of a more typical company without ".com" in its name.

It told the story of Computer Outsourcing Services, Inc. In the six years since it went public, its revenues have tripled and its earnings have quadrupled. But its stock has risen only 60%, less than a fourth of the gain in the Nasdaq Composite over that period.

In the quarter ended January 31, 1999, earnings rose 14% on a similar gain in revenues. In response, Computer Outsourcing's stock was down 23% for the year to date, versus a 17% rise for the Nasdaq index.

The result: difficulty in hiring "whiz kids" who want options on a soaring stock, trouble having acquisition bids taken seriously, and a dispirited CEO. Let's ask him "How's the market?"

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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.]

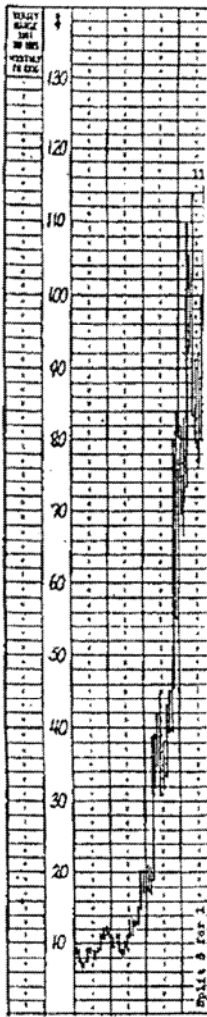
Robert Digby wrote “The South Sea Company is continually a source of wonderment. The sole topic of conversation in England revolves around the shares of the Company, which have produced vast fortunes for many people in such a short space of time. Moreover it is to be noted that trade has completely slowed 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, Healthon), 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.

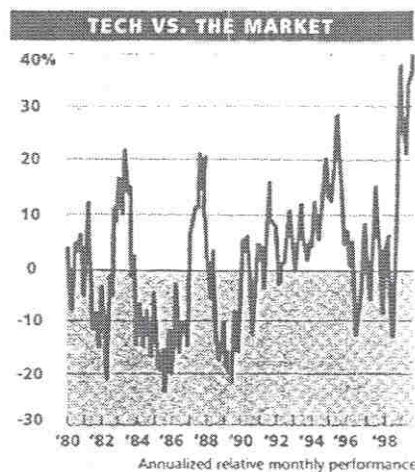
In this valuation parameter vacuum, a "lottery ticket mentality" seems to govern the purchase decision. The model for investments in the tech and dot-com companies isn't the likelihood of a 20% or 30% annual return based on projected earnings and p/e ratios, but a shot at a 1,000% gain based on a concept. 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

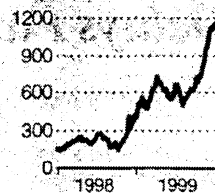
ONLY a decade ago, the Silicon Valley of California was viewed as technology's promised land, a place where bungalows cost \$1 million and even the youngest computer programmer had stock options that seemed likely to be worth millions soon.

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.

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Memo to: Oaktree Clients
From: Howard Marks
Re: Irrational Exuberance

Recent years have witnessed great excesses in the stock market. The postmortems have begun to be written, and I'm determined not to lag. Thus I will attempt below to combine a number of ideas and bits of empirical data I've stored up over recent weeks in a memo which expresses my views and hopefully is of value to you. My ideas are disjointed, but I hope to be able to fashion a common thread.

Postmortem? Do I mean to say the market's rise is over? You know I don't make predictions of that sort. **I am not ringing the bell on stock prices, but hopefully on a style of investing without reason.**

The stock market's record-breaking rise through March 10 was driven by the tech stocks. The tech stocks, in turn, were driven by optimistic, get-rich-quick buying that was totally lacking in skepticism and caution. What I think may (and should) be on the wane is the belief that it is perfectly reasonable:

- to borrow in order to buy stocks that have already risen 500% and are selling at infinite P/E ratios,
- to rely exclusively on advice from friends, **CNBC** and Internet bulletin boards when investing in companies whose business you know nothing about, and
- for companies valued at billions of dollars to lose tens of millions per year, because investors can be counted on to give them more.

These attitudes have certainly signaled **irrational exuberance**.

* * *

On December 5, 1996, with the Dow at **6,437**, Alan Greenspan coined that phrase, of which we're unlikely to have heard the last. Acting in the classic role of a central banker trying to jawbone against trends inimical to economic health, he asked:

How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions?

Did Greenspan want to stop people from having fun and making money? No. He wanted to keep stocks from running too far too fast and thus avoid an excessive wealth effect.

“Wealth effect” is the term used to describe the impact on the economy of major increases in the prices of stocks or other assets. When asset prices rise, people feel richer and spend more. When the resulting demand outstrips supply, inflation heats up. Further, when the upward trend of asset prices inevitably turns down, the wealth effect works in reverse, putting a damper on economic growth (although Greenspan is more likely to have been worried about inflation than economic softness).

Prior to expressing his concern about exuberance, Greenspan was credited with the power and wisdom needed to keep the economy rising forever. So how did investors react to his remark? In the first half-hour of trading the next day, they took the Dow down by 145 points (which used to be considered a big move). But the exuberance of which he had warned soon reasserted itself, with the Dow closing the year virtually unchanged from its pre-critique level and moving 1000 points higher over the next six months.

If it was irrational exuberance that had taken the Dow to 6,437 in late 1996, what would describe the rise to 7,437, and eventually to 11,497, in relatively short order? And what accounts for Greenspan's two subsequent years of silence on the subject? My guess is that he was feeling pressure from people – perhaps with a political stake in the continuing rise of the stock market-who castigated him for being a wet blanket.

* * *

At any rate, Greenspan's warning receded into memory without meaningfully slowing the market's rise, and his place in the pantheon of popular heroes appeared diminished. After all, a record 49% of Americans now had a stake in the stock market, and their heroes were people who helped them make money, not scolds warning about excess and pushing prices lower. Having voiced concerns and diminished confidence, Greenspan was no longer the day trader's pin-up.

When Greenspan began to raise rates on June 30, 1999, no one seemed to care. The Nasdaq Composite rose practically unabated from 2,686 at the time of the first of five rate increases to 5,049 just 8 months later. Thus Greenspan joined the roster of those whose genius was downgraded in recent times - almost comically, I think (unless you're one of the people so affected).

Another prime example is Julian Robertson, who compiled an incredible record through mid-1998, with a return averaging 31.7% a year for 18 years. Then losses and capital withdrawals knocked his Tiger Fund from \$22.8 billion to \$5.2 billion over the next 18 months. Every day the stock market was ridiculing both value investors like Robertson and the Old Economy companies they specialized in. Robertson announced a few weeks ago that he was closing up shop, saying, “we are in a market where reason does not prevail” and “there is no point in subjecting our investors to risk in a market which I frankly do not understand.”

In a supreme irony, the April week in which Robertson announced his departure turned out to be one of the best of his career, but the damage had already been done. I often think about the corrosive effect of being on the wrong side of a market judgment for prolonged periods, and the phenomenon through which those who resist trends the longest can finally capitulate at just the wrong time. Robertson, 67, had an approach that failed to work for two painful years and enough wealth to allow him to say “why put up with this?” The pressure to quit obviously hit its apex just as his timing in quitting was at its worst.

Last week saw a pullback from risk on the part of George Soros, head of the remarkable Quantum Fund (up 32%/year after fees for 30 years), and the resignation of Stanley Druckenmiller, its portfolio manager since 1989. Why? Druckenmiller had resisted tech stocks until mid-1999, but then he invested and made a bundle in the second half. When he held on to most of them in 2000, they brought him heavy losses. The New York Times reported, “... he had known by December that the explosion in technology stock prices had gone beyond reason. But he expected it would go longer than it did ... ‘We thought it was the eighth inning, but it was the ninth.’” Or as Soros admitted, “Maybe I don't understand the market. Maybe the music has stopped but people are still dancing.”

An analyst who dealt with both Robertson and Soros summed up aptly for the Times:

The moral of this story is that irrational markets can kill you. Julian said, “This is irrational and I won't play,” and they carried him out feet first. Druckenmiller said “This is irrational and I will play,” and they carried him out feet first. (Emphasis added)

And what about Gary Brinson, another top value stock investor? After he sold his firm to Swiss Bank Corp. and SBC merged with Union Bank of Switzerland, the combined firms had \$920 billion under management and Brinson appeared well on his way to becoming the world's first trillion-dollar money manager. But either Brinson or his constituents lacked the resolve needed to hang in when his approach was out of fashion, and he announced his resignation on March 2. It was probably one more case of a wealthy man who saw no good reason to continue subjecting himself to the market's insults. Brinson became yet one more stellar investor who was kept from going out on top.

By the mid-1990s, Warren Buffett had become a household name and a role model for millions of American investors. He is absolutely unique in that he became one of the world's richest men by investing in common stocks. All it took was a return averaging 25% a year for 30 years. But his portfolio was flat in the raging bull market of 1999, and the stock price of his Berkshire Hathaway lost 49% from its 1998 high to its 2000 low. Buffett certainly has been treated with less awe in the last couple of years.

Jeremy Siegel also came to be ignored. Who's Siegel? This Wharton professor was voted the best in the country, and his book “Stocks for the Long Run” contributed greatly to the bull market's middle years. He reported that there had been very few long periods of time in which stocks had lost money or underperformed bonds or cash, and this greatly

buttressed investor confidence. But when his article “Big-Cap Tech Stocks Are a Sucker Bet” ran in the Wall Street Journal on March 14, 2000, it seemed to have no immediate effect on stock prices – the Nasdaq Composite was 5% higher ten days later.

If these genuine geniuses have been dissed of late, who was elevated? Take the case of James Glassman and Kevin Hassett, **the** authors of “Dow 36,000.” Utilizing Siegel's research, they concluded that because stocks are so low in risk, they should not provide a premium return versus bonds; thus, their return in the past was far higher than it should have been. In order for stocks to offer a prospective return that is appropriately low - say 6% - their current price should be higher. The broad market's P/E ratio should be 100, and the Dow should be at 36,000 **now**. Glassman and Hassett got a lot of ink in the Wall Street Journal in 1999, but I couldn't get past one question: Who's going to buy stocks to make 6% a year?

And lastly, what about Frank P. Slattery, V, age 27, who entered the investment business in 1996. His smallish PBHG New Opportunities Fund was up 533% in 1999 and another 96% in the first 70 days of 2000. Now that's genius! (However, in the new market environment, the fund was down 57% between March 10 and April 14, wiping out all of 2000's gain and more. Slattery has resigned to pursue other opportunities.)

In the choice of who should be canonized and who downgraded, the late 1990s were certainly a time when reason was turned upside down.

* * *

Speaking of the 1990s, I was recently asked to compare the 1980s' “Decade of Greed” with the latest iteration. In the 1980s, a few financially astute leveraged buyout operators attained prominence while trying to take over some of America's leading companies without much capital of their own. In the 1990s, in contrast, it seemed everyone in America tried to get rich quickly by jumping on a perpetual motion machine.

One of the greatest irrationalities of the last few years has been the declining role of reason and fundamental business analysis in the setting of stock prices.

First, a look at trading volume convinces me that the retail investor - acting either directly or through mutual funds - increasingly became the marginal transactor setting stock prices. I doubt institutional trading could have increased enough to account for 1.5 billion shares a day on the NYSE and 2.0 billion shares a day on Nasdaq. (Circa 1980, when I bought Oppenheimer junk bonds whose interest was indexed to NYSE volume, the benchmark was the then-current average of 49 million shares a day.)

Second, with the enormous popularization of stocks in the '90s, rank amateurs were pulled in, diluting the expertise of even the retail investment community. Many of these new investors were ignorant of the process through which stock prices historically have been based on earnings and dividends. They knew only that stocks went up and tech

stocks went up faster. Valuation didn't matter: if you bought a stock with a good enough “story,” someone else would pay you more for it.

Third, the role of the brokerage house analyst changed. When I started doing equity research 31 years ago, the sell-side analyst tried to serve investors so as to attract trading and generate commissions. In the 1990s, with commission rates so low and the big money being made in investment banking, it became the sell-side analyst's job to generate capital market deal flow. The analyst tried to become influential with investors in order to endear himself to company management. Serious valuation work dwindled and “sell” recommendations became even more scarce: why antagonize a company whose investment banking business you're trying to attract? A recent Wall Street Journal quote from Morgan Stanley's Cisco analyst is emblematic of the analyst's new dog-chasing-its-own-tail role:

We have to accept the facts of life. If investors want to buy these high growth companies, we are just trying to take what they are willing to pay and translate it into a target price and therefore a stock recommendation.

In other words, it wasn't the analyst's job to throw cold water on the investor's party by pointing out that the target price had been reached or the price was too high. He just moved the target price up. And investment newcomers, unaware of how superficial this all was, actually attached some importance to the target prices assigned by analysts.

Fourth, with reason lacking, the retail investor's approach came to be based on extremely simplistic thought processes.

- When momentum investing was working, the mantra was “buy stocks that have done well - they'll keep going up.”
- When the inevitable pause in the rise swept the market - as it did in August **1998**, when Long-Term Capital and the emerging markets stumbled - the cry of “buy the dips” took hold, and it worked every time.
- On bad days recently, with the confidence behind the rise deflated (and with no reserve of reason there to back it up), I think it's been “sell before it goes down more.”

Investors with no knowledge of (or concern for) profits, dividends, valuation or the conduct of business simply cannot possess the resolve needed to do the right thing at the right time. With everyone around them buying and making money, they can't know when a stock is too high and therefore resist joining in. And with a market in free fall, they can't possibly have the confidence needed to hold or buy at severely reduced prices.

And that brings me back to one of my favorite quotations from Warren Buffett:

The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.

Unless reversed, the damage of the last few weeks clearly demonstrates the extent to which the risky behavior of others can create peril for you. **If it has taught another generation that stock ownership is not a riskless one-way street, that's a healthy development that should render such imprudent behavior less likely to reappear.**

* * *

While on the subject of investors' analytical capabilities, I want to take a look at stocks' failure for so long to respond to the Fed's rate increases. In earlier times, the market would decline as soon as a rate increase was hinted at, no less implemented. This time around, the Fed raised rates five times and Chairman Greenspan essentially came out and said the market was too high and he would bring it down. How can we explain the fact that there was no reaction (until recently, if that in fact did contribute to the correction)? I attribute this, also, to failings on the part of those setting stock prices.

There are two main reasons why stocks fall when rates rise. I'll discuss them below and offer my explanation for their failure to gain traction this time:

First, stocks dip because higher interest rates mean stiffer competition from fixed income investments. No one cared in 1999, however, because 6½% wasn't any more tempting than 6¼% to someone expecting a sure 20% from stocks.

Second, higher rates make it more expensive for consumers to buy houses and cars and for businesses to hold inventories, invest in machinery and build buildings. This puts a crimp in the pace of business and can lead to recession. But if the investors setting stock prices don't know (or care) how the economy and business cycle work, policy increases can be slow to impact the equity market.

Rate increases depress stocks in the short run when people understand how they work and anticipate the longer-term effects described above. That is, they work because people agree they will work. If this requirement isn't met, then rate rises deserve the description that First Boston's Al Wojnilower ("Dr. Doom") applied in the 1970s to manipulating the money supply: "turning on and off a light switch to which no wires are attached."

* * *

Why did stocks rise so rapidly in 1999? Because people were rabid to buy and no one wanted to sell to them. The result was explosive appreciation. Those gains actually signaled great illiquidity (which is measured as the percentage price change that results from buying or selling a certain dollar value of stock). However, an imbalance of buyers over sellers is never called illiquidity; it's called profit and doesn't worry anyone.

In the last six weeks, however, the imbalance has been on the sell side. This time, investors' inability to find others willing to trade with them has forced prices down drastically, and they are calling it illiquidity. In other words, radical upward movement was greeted warmly, but radical downward movement is being attributed somewhat to a failing on the part of the market.

Certainly the behavior of stocks in 1999 was viewed more benignly than it should have been. Momentum investors irrationally planned to get out when the music stopped, but the market wasn't able to accommodate all of them.

* * *

I want to turn now to the subject of market efficiency, something that's very important to us at Oaktree and that I have been looking for a chance to discuss.

In recent weeks I've heard good things about a new book, fittingly titled "Irrational Exuberance." Its author, Robert J. Shiller, a Yale economist, has taken on the theory that the stock market is efficient, saying stocks' swings are too violent to suggest that they are always accurately valued. On that famous Tuesday four weeks ago, the Nasdaq Composite traded at both 3,649 and 4,138 within seventy minutes. It's certainly hard to believe the underlying stocks were fairly valued at both levels. No, says Shiller, the stock market is not efficient; stock prices are set irrationally. Or as George Gilder recently wrote in the Wall Street Journal:

Stock markets are world-wide webs of information. So why half the time do they behave like members of some candy mountain mystical sect, torn between dreams of eternal wealth and horror of a bottomless pit?

In response, I want to give my view of market efficiency. I want to say up front that academics don't share my view and theory says I'm wrong. But my approach works for me, and I want to share it with you.

In my opinion, the market for many stocks is highly efficient. That's what I was taught at the University of Chicago in the mid-'60s, when capital market theory was being developed. And in 1978, when I left equity research, I told Citibank I'd do anything but "spend the rest of my life choosing between Merck and Lilly." I believed in market efficiency then and I believe in it now. But what does that mean?

When I say efficient, I mean "**speedy**," not "right." My formulation is that analysts and investors work hard to evaluate all of the available information such that:

- the price of a stock immediately incorporates that information and reflects the consensus view of its significance, and
- thus, it is unlikely that anyone can regularly outguess the consensus and predict a stock's movement.

That is, the market may often misvalue stocks, but it's not easy for anyone person - working with the same information as everyone else and subject to the same psychological influences - to consistently know when and in which direction. That's what makes the mainstream stock market awfully hard to beat - even if it isn't always right.

* * *

Lastly, I want to share what I told the board of a charity whose Investment Committee I chair. I listed some of the elements that have been at the foundation of prudent investing during my time in the business and more:

- pursuing both appreciation and income,
- balancing growth and value investments,
- balancing the desire for gain and the fear of loss,
- buying companies with a history of profitability,
- caring about valuation parameters,
- emphasizing cheap stocks,
- taking profits and reallocating capital,
- rotating industries, groups and themes,
- diversifying,
- hedging,
- owning some bonds, and
- holding some cash.

How did this list do in 1999? **It was a recipe for disaster!** Every one of these elements would have caused you to underperform. What should you have done? Just two things:

- bought growth and technology stocks that had already appreciated, and
- held them as they rose further, refusing to sell at any price.

Thus in one more way, wisdom was turned on its ear in this period.

* * *

Robertson, Soros, Druckenmiller, Brinson and Buffett succeeded for decades because the markets they worked in (1) were driven by both fear and greed, (2) responded eventually to reason, and (3) rewarded disciplined analysis more than they did naked aggressiveness. That's the kind of climate we at Oaktree prefer. In the late 1990s, markets were propelled (and the big money was made) by people who, in my opinion, substituted optimism, risk tolerance and love of a good story for reason, caution and skepticism. If investors have been chastened by the events of the last few weeks, I think we'll see more of the latter in the future.

May 1, 2000

P.S.: I've learned the hard way that it's not easy to be right about the future, as I've been complaining about market excesses for far too long. That being the case, I'm not going to miss the opportunity to celebrate the correctness to date of my last memo, "bubble. com." The table below lists the stocks mentioned in that memo and their declines from its publication at year end, and from the highs reached since then, to the April trough.

Company	Ticker	12/31/99	2000 high	4/14/00	%Chg	% Chg
					12/31/99	2000 high to 4/14/00
Akamai Tech.	AKAM	\$328	\$321	\$ 65	-80%	-80%
Amazon.com	AMZN	76	89	47	-38	-48
America Online	AOL	76	83	55	-28	-34
Charles Schwab	SCH	38	65	41	6	-38
CMGI	CMGI	138	163	52	-62	-68
E*Trade	EGRP	26	33	19	-27	-41
Egreetings Network	EGRT	10	12	3	-68	-74
Etoys	ETYS	26	26	5	-82	-81
Priceline.com	PCLN	47	96	59	24	-39
Red Hat	RHAT	106	141	24	-77	-83
theglobe.com	TGLO	8	9	3	-64	-67
VA Linux Sys	LNIX	207	193	29	-86	-85
Webvan	WBVN	17	18	6	-66	-69
Yahoo!	YHOO	216	238	116	-46	-51
Average					-50%	-61%

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Memo to: Oaktree Clients
From: Howard Marks
Re: Investment Miscellany

Because I've been encouraged by the response to my "bubble. com" and venture capital memos, I'm going to keep writing. Over time, I collect ideas that I'm tempted to pass on to you - nothing major, but miscellany that may be of interest. Sharing them might become a habit; let me know if you think it should.

Can't Get Any Respect

The behavior of IPOs and hot tech stocks in the last few years perverted everything that traditionally had held true. The episode that crested in March must have been the greatest bubble of all times. Certainly money was made in amounts and at speeds never seen before. Companies went from business plan to IPO in a year or two, with billions of dollars assigned to them in market capitalizations or bestowed on their founders and venture capital backers.

In the last twelve months, technology entrepreneurs and investors on both coasts bought homes costing several tens of millions of dollars. The line of eager buyers pushed up prices for private planes, yachts and beachfront homes. The market for art and antiques grew white hot. In short, as a friend of mine says, "money was disrespected."

Traditional investing values were equally disrespected. Risk was viewed as the investor's friend, and caution as unnecessary and unavailing. Profits - and even profit projections - were considered superfluous. The slow and steady ways of making money came in last, and the riskiest schemes paid off best. Venture capital funds produced triple-digit returns in a year, and profitless technology company IPOs did so in a day.

On the other hand, investors seemed incapable of remembering why they had fixed income allocations, and value stocks and absolute return strategies weren't far behind in terms of disregard. In May of 1999, I heard John Angelo of Angelo Gordon put it brilliantly:

Twenty years ago, when I told people I could make them 15% a year, year in and year out, they said "That's impossible." Today, when I tell people I can make them 15% a year, year in and year out, they say "Who cares?"

To illustrate, take the case of high yield bonds, whose prices have been sagging, partly because of steady capital flows out of high yield mutual funds (for redeployment in equity funds). I was asked the other day when flows into high yield bonds would resume. My answer: When people realize once again that 11 % is a good return.

But this disrespect for traditional investment thinking shall pass--and in fact it appears to be in the process of doing so. In general, the portfolios that did best last year have done worst so far this year, and vice versa. Traditional investing values will be respected again. I can even imagine a day when words like "prudence" return to investors' everyday speech.

It Restores Your Faith

If common sense and logic don't work, how are we to run our lives? In "bubble.com" I battologized (look that up in your Funk & Wagnall's) regarding the dot-coms' divergence from the old-fashioned notion that only if revenues exceed expenses is a business attractive. Instead, in 1999 business models were based on giving away products as a way to get ads in front of eyeballs, or on selling things for less than they cost.

WebHouse Club is a poster child for failed giveaways. A spin-off of Priceline.com, it let customers name their own price for groceries and gas. There was a problem: manufacturers were unwilling to supply goods at the prices customers wanted to pay, so WebHouse made up the difference. In "bubble.com" I related several old jokes about the businessman who sells below cost, but I never expected to see life imitate art so precisely. Anyway, WebHouse's backers lost their enthusiasm for absorbing the losses (the fall of their Priceline stock from \$170 to \$3 may have had something to do with it), and the company ceased doing business on October 5.

I find it reassuring that entrepreneurs (and, more significantly, the investors expected to fund them) are realizing that profitless "business models" are untenable. Internet retail firms are shutting down, especially those in overpopulated "spaces." Now, I'm told, the newest "b-to-c" among Silicon Valley employees is "back to consulting." Last year, Goldman Sachs had trouble recruiting the **MBA** it needed; this year the interview rooms are overcrowded again.

What Can Reasonably Be Expected from Equities?

In a little drama that I'm sure has played out at thousands of organizations in the last year, a charitable organization investment committee that I chair began to question its conservative portfolio and ask whether it should have more in equities. As a result, we commissioned some bond/stock allocation work from our consultants. Its conclusions were most curious.

Their model called for higher equity allocations, predicting that they would lead to higher overall returns on the portfolio and lower risk. Why? Because equities were projected to return 14% and risk was defined as the probability of failing to average 8% over a five-year period.

First, I said, I would never have any part in a process that equated higher equity allocations with lower risk. I suggested that risk be defined as overall portfolio volatility, and that took care of that.

But second, I questioned the 14% projected return from equities. Equities returned 28% in 1995-99, I said; did someone think halving that made for a conservative projection? No, I was told, the support mostly came from the 13% long-run return on equities:--(I always thought it was 10% or so, but it seems the last five years have changed all that.)

I could only think of one way to respond: I offered to put up my money against that of the consultant's researchers and "take the under." I doubt strongly that equities will return 14% or anything like it in the next decade. Corporate earnings have traditionally grown at single-digit rates, and I don't feel that's about to change substantially. With p/e ratios unlikely to rise further and dividends immaterial, single-digit earnings growth should translate into single-digit average equity performance at best for the foreseeable future.

In the end, I feel there has been unreasonable reliance on the average historic return from equities, be it 10% for 1929-92 or 13% for 1940-99. What's been lost track of is the fact that p/e ratios were much lower when these periods began and since then have risen substantially. I just don't believe that further p/e expansion can be counted on. How do I view the issue? I ask the bulls one question: **What's been the average performance of stocks bought at p/e ratios in the twenties?** I don't think the return has been in double digits. I'm not even sure it's been positive.

A Framework for Understanding Market Crisis

I want to call your attention to an excellent paper with the above title written by Richard Bookstaber, head of risk management for Moore Capital Management. It was published in the proceedings of an AIMR seminar on "Risk Management: Principles and Practices" (August, 1999). What smart people do is put into logical words the thoughts we may have had but never formulated or expressed. In his article, Bookstaber has done a great job of explaining the forces behind market crisis.

I'll try to summarize his analysis, borrowing extensively from his words but adding my own interpretation **and** emphasis, there'll be some slow going, but I think you'll find it worthwhile.

- Most people think security price movements result primarily from the market's discounting of information about corporate, economic or geopolitical events - so-called "fundamentals." If you sit with a trader, however, it's easy to observe that prices are always moving in response to things other than fundamental information.

- Bookstaber says “the principal reason for intraday price movement is the demand for liquidity In place of the conventional academic perspective of the role of the market, in which the market is efficient and exists solely for informational purposes, this view is that the role of the market is to provide immediacy for liquidity demanders.....**By accepting the notion that markets exist to satisfy liquidity demand and liquidity supply, the framework is in place for understanding what causes market crises, which are the times when liquidity and immediacy matter most.**”
- “Liquidity demanders are demanders of immediacy.” I would describe them as holders of assets in due course, such as investors and hedgers, who from time to time have a strong need to adjust their positions: When there's urgency, “the defining characteristic is that time is more important than price they need to get the trade done immediately and are willing to pay to do so.”
- “Liquidity suppliers meet the liquidity demand.” They may be block traders, hedge fund managers or speculators with ready cash and a strong view of an asset's value who “wait for an opportunity when the liquidity demander's need for liquidity creates a divergence in price [from the asset's true value]. Liquidity suppliers then provide the liquidity at that price.” What they offer is liquidity; providing liquidity entails risk to them (which increases as the market's volatility increases and as its liquidity decreases); and the profit they expect to make is their price for accepting this risk. “To liquidity suppliers, price matters much more than time.”
- Usually when the price of something falls, fewer people want to sell it and more want to buy it. But in a crisis, “market prices become countereconomic,” and the reverse becomes true. “A falling price, instead of deterring people from selling, triggers a growing flood of selling, and instead of attracting buyers, a falling price drives potential buyers from the market (or, even worse, turns potential buyers into sellers.)” This phenomenon can occur for reasons ranging from transactional (they receive margin calls) to emotional (they get scared). The number of liquidity demanders increases, and they become more highly motivated. “Liquidity demanders use price to attract liquidity suppliers, which sometimes works and sometimes does not. In a high-risk or crisis market, the drop in prices actually reduces supply [of liquidity] and increases demand.”
- In times of crisis, liquidity suppliers become scarce. Maybe they spent their capital in the first 10% decline and are out of powder. Maybe the market's increased volatility and decreased liquidity have reduced the price they're willing to pay. And maybe they're scared, too. Bookstaber recalls the Crash of 1987. After the first leg down, liquidity suppliers “had already ‘made their move,’ risking their capital at much lower levels of volatility, and now were stopped out of their positions by management or, worse still, had lost their jobs. Even those who still had their jobs kept their capital on the sidelines. Entering the market in the face of widespread destruction was considered imprudent ... Information did not cause the dramatic price volatility. It was caused by the crisis-induced demand for liquidity at a time that liquidity suppliers were shrinking from the market.”

- “One of the most troubling aspects of a market crisis is that diversification strategies fail. Assets that are uncorrelated suddenly become highly correlated, and all positions go down together. The reason for the lack of diversification is that in a [volatile] market, all assets in fact *are* the same. The factors that differentiate them in normal times are no longer relevant. What matters is no longer the economic or financial relationship between assets but the degree to which they share habitat. What matters is who holds the assets.” In recent years, the “habitat” in which most investors feel comfortable has expanded. Barriers to entry have fallen, access to information has increased and, perhaps most importantly, most investors' forays abroad have been rewarded. Thus “market participants become more like one another, which means that liquidity demanders all [hold] pretty much the same assets and grab whatever sources of liquidity are available.” If they **are held by the same-traders, “two types of unrelated-assets will become highly correlated because a loss in the one asset will force the traders to liquidate the other.”** That's not a bad explanation for the fact that when Long-Term Capital and the emerging markets crashed in September 1998, high yield bonds and other unrelated asset classes fell with them.

I hope you'll recognize in the above some of the elements behind the Oaktree approach, as exemplified by our work with distressed debt.

- We look for Bookstaber's “liquidity demanders,” with their exogenous motivations. We call them forced sellers, and they provide our best bargains.
- We take advantage when “noneconomic” market conditions increase the pressure to sell even as asset prices move lower.
- And we rarely approach holders to buy, preferring to wait until they call us. In that way we are “liquidity suppliers” rather than eager buyers. Take it from me, the latter pay more.

Many of us may have had thoughts like Bookstaber's, and in my 30+ years in money management I've had plenty of chances to watch liquidity demand **soar**, liquidity supply dry up, prices collapse and diversification fail. But I respect someone who can put into a rigorous framework that which “everybody knows.”

Speaking of panics, we all recognize the carnage that occurs when the desire to sell far exceeds the willingness to buy. But I think Bookstaber's analysis applies equally to the opposite - times when the desire to buy outstrips the willingness to sell. It's called a buying panic and represents no less of a crisis, even though - because the immediate result is profit rather than loss - it is discussed in different terms. Certainly 1999 was just as much of an irrational, liquidity-driven crisis as 1987. While some of the ramifications have been seen thus far this year, I think there's more to come.

Knowledge Versus Information

If Bookstaber's article made brilliant sense of a market phenomenon, what's the opposite? For an example, I would look to "Stock Hoax Should Affirm Faith in Markets" by James K. Glassman (Wall Street Journal, August 30). Glassman's name may be familiar to you, because my memo of May 1, 2000 took issue with "Dow 36,000," a book he co-authored. Now it's a pleasure to take issue with him again.

Glassman's book said the Dow should be at 36,000 because stocks' multiples should be much higher than they are. Multiples should be higher because there's so little risk in stocks, and thus investors needn't incorporate a risk premium. I didn't think that argument made any sense, and I don't think the recent article makes any, either. This time, Glassman argues that one of the things greatly reducing the riskiness of stocks is the technology being employed in the markets, most notably the Internet. Because information is disseminated so rapidly and thoroughly, investing entails less risk, so stocks are a better place to be. As he puts it, "The Internet - simply as a tool to get financial information out speedily - has had the effect of raising stock prices, perhaps permanently. In that way, the new technology has added hundreds of billions of dollars to the wealth of U.S. investors."

Paradoxically, Glassman finds proof of this in the Emulex incident. On August 25, 2000, a false press release was picked up on the Internet, taking Emulex stock from \$103 to **\$45** within twenty minutes. After a few-hour trading halt, corrected information took it back above \$100. Glassman's term for the markets: "dazzling in their efficiency."

He finds comfort in the fact that both the falsified data and the correction were disseminated so quickly. I feel the rapid and universal distribution of information - often at speeds and in amounts that make it impossible to verify, distill and understand - does nothing to make the markets safer *per se*. For proof, look at the trend in volatility. It seems inescapable that media hype and other short-term oriented developments have made the markets more treacherous.

Looking at today's mass market and the associated flood of information, my partner Sheldon Stone sees investors as passengers on a boat, running back and forth *en masse* -to one side in response to new information, and then back to the other. That makes for a rocky crossing.

Where does Glassman go wrong? To me, his error is obvious in the following sentence:

Markets know so much more about companies, and know it so quickly, that their assessments of worth have an up-to-the-minute efficiency and accuracy.

The bottom line for me: **Efficiency and accuracy are two very different things.** As I wrote in my May memo, investors rapidly incorporate new information into their estimates of security values, and the market rapidly reflects the consensus view of values,...but that doesn't mean the consensus is right. **Information isn't knowledge.** The mere fact that investors have data doesn't mean they understand its significance. If investors' knowledge was really growing, stock volatility wouldn't be increasing as dramatically as it is. As the adage says of the fool, "he knows the price of everything and the value of nothing."

November 16, 2000

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Memo to: Oaktree Clients
From: Howard Marks
Re: We're Not In 1999 Anymore, Toto

In "The Wizard of Oz," a tornado carried Dorothy and her dog, Toto, to a land ruled by a mysterious despot in whom people had vested extraordinary powers. In the investment world of 1999, similarly, the promise of easy money powered a wild ride into a world in thrall to high tech investing. Both of these seemingly omnipotent forces were eventually exposed as vulnerable, however, and the spells surrounding Oz and the stock market were broken.

* * *

In my favorite commercial of 1999, Stuart, the cyber-geek from the mailroom, exhorted his boss to make his first on-line stock purchase, saying, "Let's light this candle!" When Mr. P. protested that he didn't know anything about the stock, Stuart suggested, "Research it." Mr. P. pushed a button on his keyboard and a few seconds later, suddenly wiser, proceeded to buy his first hundred shares. Like many, he demonstrated how easy it is to feel smart in a bull market.

In 2000, on the other hand, on-line brokerage commercials were different. When the little boy asked his father what he was doing at the computer, the father said he was investing for his college education. Looking over his dad's shoulder, the boy was curious about the on-screen data. "Five-year earnings, p/e ratio . . ." the father enumerated. "A p/e ratio of 23," the son asked, "is that good?" The father's dumbfounded silence clearly reflected his sudden realization that he knew less than he had thought.

Obviously, in 2000, millions of investors across the board realized that they knew less than they thought they did, and that lots of what they had been sure of was wrong.

* * *

A year ago, I wrote in "bubble. com" that tech stocks had benefited in 1999 from a boom of colossal proportions. They exhibited all of the elements of a market bubble, with an attractive story providing the foundation for a gravity-defying escalation of prices far beyond reason, and for manic behavior on the part of investors. I urged readers to view the tech stocks skeptically, but I also acknowledged that it's possible for overpriced assets

to remain so for a long time. **I certainly had no idea that the excesses I saw in the market would be remedied as quickly as they have.**

The Bubble Bursts

In every regard enumerated in "bubble.com" and more, the tech-media-telecom extremes of 1999 were reversed in 2000. I must say I've never seen anything quite like it.

Business models questioned – A year ago, I went to great lengths criticizing dot-com business models that valued eyeballs over profits and viewed operating losses as a good investment. This year, investors realized that the emperor was naked. The first signs came in articles like "Burning Up" (Barron's, March 20), which cited the rate at which Internet companies were using their finite cash to fund operating losses. More recently, "The Giveaway Is Going Away On Web Sites" (Wall Street Journal, December 4) stated that "many of the online companies that are in a sad state today can blame their woes on the cornucopia of free stuff and services they have been doling out to build market share." So now it's "p-to-p," or path-to-profit . . . just a little late. Technology entrepreneurs went through their cash, secure in the expectation that they could always raise more by selling shares to eager buyers. In today's market, as the British say, that's simply not on.

Technology firms disrespected – Prospective investors (not to mention bankers, suppliers and landlords) now want to see profit potential. The laws of business are being enforced, meaning that money-losing companies can't attract additional capital. Scores of firms have closed, and tens of thousands of employees have lost their jobs. In perhaps the height of indignity, the Internet has been turned against its own, as dot-coms have been formed to chronicle the collapse of dot-coms. Log on to dotcomfailures.com for a list of more than eighty.

Tech/media/telecom stocks brought low – Of course, the stocks that soared in 1999 tanked in 2000. The 86% gain of the **NASDAQ** Composite in 1999 was the greatest in history for any major average. Its 39% loss in 2000 was the greatest in its history and, in terms of major averages, trailed only the 1931 drops in the Dow and S&P.

Throughout my 30-plus years in the investment business, I have seen one localized boom after another. Each time, the end was marked by a Wall Street Journal table cataloging once-hot stocks that had fallen more than 90% from their highs. Conglomerates (late 1960s), computer software and services (1969-70), the Nifty-Fifty (1973-4), oil stocks (early '80s) and biotech (early '90s) – they've all been there, and I felt certain that TMT stocks would join them sooner or later. The only difference is that in 2000, the top ten losers on the NASDAQ all declined **more than 99%!**

The 14 stocks mentioned a year ago in "bubble.com" provide a pretty good sample; they're down 82% on average from their year-end 1999 prices and 87% from their highs in 2000. Eight of the fourteen are down 96% or more from the top (see the table on the last page for the details).

IPOs no longer a sure thing – If you ask me, the most important single contributor to the tech stock bubble was the mania for Initial Public Offerings. When new issues began to double, triple and more on their first day of trading - and then triple again from there - a gold rush started. When the stock market valued profitless new ventures, only months after their formation, at multiples of their sales (and, illogically, at multiples of the price at which founders were gladly to sell), anything was possible. The lottery was on, and the improbable but huge payoffs going to the winners made every ticket valuable. Later, investors ignored the odds against success and acted as if all of the companies - even head-to-head competitors-would be winners. The perpetual motion machine eventually lost its momentum, of course, and it turned out that there's no sure thing. Although the IPOs of 2000 averaged a first-day gain of 55%, about two-thirds of them are now trading below their issue price.

Venture capital rendered mortal – 1999 witnessed the wildest single market phenomenon I've ever seen: an asset class with a triple-digit annual return. The overheated IPO market provided an exit for the venture capitalists and contributed greatly to their fabulous profits. The model was simple: create a business plan (on the proverbial napkin), raise a little money, staff up and open the doors, spend wildly to build demand for products sold at a loss and go public at a hundred - or a thousand - times invested cost. In contrast to last year's banner headlines, 2000's venture capital stories are a little murkier. How did the funds do in 2000? Given the vagaries of pricing and the lags in reporting, no one has a good reading on performance yet.

I want to highlight one thing, though: venture capital funds often distribute shares to investors and reckon the amount distributed based on the market price of the stock at the time. But if investors don't realize that price, their actual returns may be far lower than those claimed by the funds. If the subsequent declines are charged to the investors' public stock portfolios, we may never know what venture capital returns really were.

Analysts defrocked – I think one of the usual hallmarks of a market mania is personification. This time around, the heroes included brokerage firm analysts like Mary Meeker and Henry Blodget, who were lionized in Internet chat rooms and whose target prices for stocks were given great credence by investors. It turns out, though, that many analysts weren't basing their targets on analytically-derived profit and p/e estimates but, in a stunning circularity, on what they thought investors might pay. It's now clear the analysts added little insight in terms of either fundamentals or valuation.

The December 18 Wall Street Journal revisited six price targets. On average, the analysts predicted a 64% gain, but the stocks declined 88% instead. For me, the most telling thing was one analyst's alibi: "By setting [the target] only about 25% higher. . . we were indicating there was only a little more upside in the stock." I seem to remember when calling for a 25% gain was a bullish statement, not a warning. But then again, all kinds of nutty behavior typified this bubble.

Odds and ends at the extreme - Numerous other elements, large and small, captured the excesses of the tech stock mania and their reversal.

- In 1999, incubators (CMGI and Internet Capital Group), technology industry participants (Intel and Amazon) and outsiders (Starbucks) were piling up profits in venture investments. This year, of course, it was losses that fell to the bottom line.
- The potential for stock option profits made dot-com jobs compellingly attractive last year, and old economy firms had no way to compete. This year, employees wanted cash instead, and what we read about is the negative effect of stock options on companies' finances.
- Last year, the media told of executives jumping from the old economy to dot-coms. This year's stories described surprise firings and careers left in the lurch.
- In 1999, brokerage house Internet conferences drew big crowds. 2000 saw conferences postponed and cancelled.
- Whereas tech stocks commonly reached triple-digit prices in 1999, now they're falling below \$1 and being delisted by NASDAQ.
- Instead of experiencing dramatic capital inflows and perhaps closing to new investors, tech and Internet mutual funds are diversifying into other areas, merging with other funds or shutting down.
- Finally, in the most visible indicator, we'll see on January 28 that dot-coms will run only about 10% of the commercials during the Superbowl, down from 50% last year.

Of course, the bottom line is that lots of things people considered eminently logical in 1999 – like low-risk triple-digit gains – are now being shown to have been far too good to be true. The headlines of 1999 look silly now, and the debunking in 2000 seems obvious (e.g., "What Are Tech Stocks Worth, Now That We Know It Isn't Infinity?" in the Wall Street Journal on April 17). But that's a juxtaposition that marks the end of every market boom.

How'd We Get Here?

In the 1990s, positive macro forces contributed to an extremely benign environment and steadily reinforced each other:

- low inflation,
- the shift of the federal budget from deficit to surplus,
- easy money at low interest rates,
- technological gains, and
- a high degree of risk tolerance.

These things gave rise, in turn, to the elements of economic and investor prosperity:

- strong corporate and individual borrowing, leading to leveraged balance sheets,
- aggressive buying by businesses, consumers and investors,
- massive gains in productivity,

- unusually rapid growth in corporate profits, and
- strong appreciation in asset prices.

Now, with some of the props removed or in question, we are seeing:

- retail and auto sales down,
- consumer and investor confidence off,
- factory orders falling and layoffs on the rise,
- profit warnings everywhere,
- risk aversion that has reasserted itself (or should we call it fear?),
- rising defaults, bankruptcies and troubled bank loans, and
- significantly lower stock and corporate bond prices.

All of this is normal cyclical behavior. Cycles are one of the few things we can rely on, as you have heard me say repeatedly, and this downswing is moving along familiar lines. What surprised even me this time around is the rapidity and severity of these developments. Given the extreme nature of the ascent, though, I guess an equally extreme reversal is not unreasonable.

Of course, former bulls will say this downturn was initiated/accelerated/exacerbated by unforeseen developments that blindsided them: skyrocketing prices for oil, gas and electric power; rising tensions in the Middle East; and the bizarre post-election chaos. But the important point is that something eventually derails every Pollyanna scenario. In 1998, I criticized the oxymoronic attitude exemplified by "we're not expecting any surprises." Somehow, surprises always seem to occur. Expectations (and stock prices) that assume there won't be any are dashed sooner or later, and optimism turns to disappointment.

I date this cycle's turning point in investor psychology to the third quarter of 1998, with the Russian default and the collapse of Long-Term Capital Management. Before that, investors seemed to consider risk their friend. They blithely interpreted the upward-sloping path of the Capital Market Line to mean that bearing more risk would reliably bring more return. (For example, one consultant told me his firm wouldn't recommend Oaktree's high yield bond management because they "wanted to maximize risk" and knew they couldn't accomplish that with us.) But the Russia and Long-Term fiascoes popped that balloon and reminded participants that risk-taking isn't always profitable.

Here's an illustration of the impact of these events on psychology. According to CSFB, from the end of 1996 to the middle of 1998, the face amount of "distressed" bonds yielding more than 20% (and thus indicating grave concern over credit) grew just \$6 billion per year on average. But in the 2-1/3 years following Russia and Long-Term, from mid-1998 through October 31, 2000, the amount increased by an average of \$38 billion per year. Actual defaults grew only half as much over that period, (\$18 billion per year), but investors' sharply reduced willingness to bear risk caused the distressed bond count to explode upward.

(If I'm right in saying risk tolerance turned to risk aversion in 1998, you might ask how the tech/media/telecom boom could have continued into 1999 and early 2000. The answer: it's the exception that proves the rule. Even as investors were turning more conservative and capital was being withdrawn from hedge funds and banks' and brokers' proprietary portfolios, the crowd took to TMT investing in a way that ignited the IPO boom and everything that followed. It's often said that at the end of a bull market the vast majority of stocks weaken while one popular sector goes on to a highly extended extreme before collapsing. Certainly that's what happened in 1999, when the tech-dominated NASDAQ rose 86% at the same time that the S&P 500 excluding technology was up only 3% (Wall Street Journal, December 21).

In 2000, the last holdouts – the TMT aficionados – finally realized that they had overstated their companies' potential, ignored their dependence on a benign environment, understated the danger implied by the market's manic volatility and paid too much for their stocks. All of the positives of 1999 turned into negatives, with catastrophic results.

The declines in the TMT stocks in 2000 provide a tangible reminder that psychology can change much faster than fundamentals. A little fundamental deterioration, when mixed with increased pessimism, can wreak absolute havoc with asset prices.

Now What?

I see little chance that the boom-creating factors enumerated above – the hallmarks of the 1990s – will characterize the next few years. In particular, I see higher risk aversion and tighter credit. But, of course, the prices of many stocks and bonds in the tech sector have undergone serious corrections. So the question to ask is "Have they fallen enough?"

The answer is simple: I don't know. Nokia is down 55% from its high but still trades at 61 times earnings (New York Times, December 21). Qualcomm fell 53% but is still at 65 times expected earnings (Los Angeles Times, December 31). Overall, the NASDAQ Composite, which includes many profitless companies, is valued at 90 times its companies' total earnings (Wall Street Journal, December 20).

No one can know which way a market's going to go, but a few eternal truths and the right mindset – the significance of which has been reinforced by the experience of the last few years – can best prepare us to handle the inevitable uncertainty.

Beware of generalizations – Most of the time, and especially at the extremes, markets over-generalize. Last year, investors acted as if all of the telecom companies would succeed; this year, investors seem to think they're all losers. In 1996 and 1997, financial institutions would lend to anyone; now, even strong companies have trouble getting capital. When the market "throws the baby out with the bathwater," as we believe it's doing now, gems can often be found among the wreckage. As a result, for example, our Distressed Debt and Principal groups are prospecting for overlooked values in telecom. Also flawed are many of the broad rules that investors invoke. In 1999, no cry was heard more often than "buy the dips." Each time the market dropped a bit, buyers stepped in.

Anyone who bought in those declines benefited from the rallies that surely followed. Of course, that didn't work quite so well in 2000. The dips in March-April, May and July were all followed by rallies, but they were traps for unsuspecting buyers. Only "sell the rallies" proved correct.

Respect cycles – 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.

That was really the problem with the 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 will bring imitation and competition, which will 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.

Worry about time – Another element that investors ignore in their optimism is time. 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 everything on a long-run phenomenon, remember 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, you can rest assured that equity returns will be superior. For someone with a thirty-year time frame, the decline of the NASDAQ in 2000 may have been a matter of indifference. But it didn't feel that way to most people.

Time came into play in another way for the TMT 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 capital was denied even to worthwhile ideas. Lots of companies never got the chance to reach profitability. More important than money, they ran out of time.

Remember that, for the most part, things don't change – The five most dangerous words in our business aren't "The check's in the mail" but "This time it'll be different." Most bubbles proceed from the belief that something has changed permanently. It may be a technological advance, a shortage or a new fad, but what all three have in common is that they're usually short-lived.

Most "new paradigms" turn out to be just a new twist on an old theme. No technological development is so significant that its companies' stocks can be bought regardless of price. Most shortages – whether of commodities or securities – ease when supply inevitably rises to meet demand. And no fad lasts forever.

Never forget valuation – The focus may shift from dividend yield to p/e ratio, and people may stop looking at book value, but that doesn't mean valuation is 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, the "greater fool theory" only works until it doesn't. Valuation eventually comes into play, and those who are holding the bag when it does are forced to face the music.

Be conscious of investor psychology – I don't believe in the ability of forecasts or forecasters to tell us where prices are going, but I think an understanding 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 terrified, the prices they set are low, and we can be aggressive. On December 22, in "Consumer Mood Swings to Angst," the New York Times employed a new phrase: "irrational anxiety." If that sentiment does come to be widespread, replacing irrational exuberance, it can signal a buying opportunity.

Check your own mindset – For me, mindset holds many of the keys to success. We at Oaktree believe strongly in **contrarianism**. As suggested in the paragraph above, 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.

Closely related to contrarianism is **skepticism**. It's a simple concept, but it has great potential for keeping us 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 dot-coms, portfolio insurance, "market neutral" funds or the "Asian miracle." Oaktree was founded 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.

We think **humility** is essential, especially concerning the ability to know the future. Before we act on a forecast, we ask if there's good reason to think we're more right than the consensus view already embodied in prices. As to macro projections, we never assume we're superior. About under-researched companies and securities, we think it's possible to get an edge through hard work and skill.

Finally, we believe in **investing defensively**. That means worrying about what we may not know, about what can go wrong, and about losing money. If you're worried, you'll tend to build in more margin for error. Worriers make less when everything goes right, as in the tech bubble, but they also lose less – and stay in the game – when things return

to earth. At Oaktree, we're guided more by one principle than any other: **if we avoid the losers, the winners will take care of themselves.**

These are the things that Oaktree is built on, and that got our clients through 2000 in one piece. We can't promise that all of our investment decisions will be correct, but we can assure you they will embody these crucial ingredients for success in 2001 and beyond.

December 31, 2000

Stocks Mentioned In "bubble.com" – January 1, 2000

<u>Company</u>	<u>Ticker Symbol</u>	<u>Price 12/31/99</u>	<u>2000 High</u>	<u>Price 12/31/00</u>	<u>% Chng. 12/31/99 to 12/31/00</u>	<u>% Chng. 2000 high to 12/31/00</u>
Akamai Tech.	AKAM	\$328	\$346	\$ 21	-94%	-94%
Amazon.com	AMZN	76	92	16	-80	-83
America Online	AOL	76	83	35	-54	-58
Charles Schwab	SCH	26	45	28	+11	-37
CMGI	CMGI	138	164	6	-96	-97
E*Trade	EGRP	26	33	7	-72	-78
Egreetings Network	EGRT	10	13	#	-97	-98
Etoys	ETYS	26	28	#	-99	-99
Priceline.com	PCLN	47	104	1	-97	-99
Red Hat	RHAT	106	148	6	-94	-96
Theglobe.com	TGLO	8	10	#	-96	-97
VA Linux Sys	LINUX	207	208	8	-96	-96
Webvan	WBVN	17	19	#	-97	-97
Yahoo!	YHOO	216	250	30	<u>-86</u>	<u>-88</u>
Average					-82%	-87%

= below 50¢

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Memo to: Oaktree Clients
From: Howard Marks
Re: Safety First . . . But Where?

Are you from the old school? Do the following terms sound familiar?

- fiduciary duty
- preservation of capital
- risk aversion
- dividend yield

Although in common use prior to the 1980s, they've been heard less and less since then. For this reason, a score of zero means you are completely modern, two means you're so-so, and four means you are far behind the times. I fall solidly into the last category. That means much of what I heard and read in the late 1990s made absolutely no sense to me.

Of course, just as momentum investing eventually gives way to contrarianism (and vice versa), periods when carefree investing is highly rewarded eventually come to an end, as happened in 2000. I am writing to explore the question of where to look for successful investments when sheer aggressiveness stops paying off.

"A-B-C," my Uncle Jack used to say when he taught me how to cross the street, "always be careful. Stop and look both ways." Most of us start off that way, but after a period when few cars come and the people who rush headlong get there fastest, caution sometimes is cast aside.

Just as standing frozen with fear is no way to move ahead, investors occasionally are issued a reminder that not worrying about danger can be just as foolish. Pursuit of return must be balanced against aversion to risk. The latter came to be accorded far too little attention as the 1990s wore on, but that seems to have been corrected. Where can we look now for good risk-adjusted returns?

What's Been Tried?

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 over the last 200 years looks like a straight line from lower left to upper right. Evidence like this convinced people to increase their equity allocations 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% per 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 returns roughly paralleled profit growth in the long run.

There always will be bull markets and bear markets. The bull markets will be welcomed warmly and unskeptically, because people will be making money. They will be propelled to great heights, usually by the rationalization that "it's different this time; 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 equity investors who lost half their money.

The bottom line is that risk of fluctuation is always present. Thus stocks are risky unless your time frame truly allows you to live through the downs while awaiting the ups. Lord Keynes said "markets can remain irrational longer than you can remain solvent," and being forced to sell at the bottom – by your emotions, your client or your need for money – can turn temporary volatility (the theoretical definition of risk) into very real permanent loss. Your time frame does a lot to determine what fluctuations you can survive.

Active management – In order to get more out of the ups 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.

As you know, I believe most markets are relatively efficient, and that certainly includes the mainstream stock market. Where lots of investors are aware of an asset's existence, feel they understand it, are comfortable with it, 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 can consistently know 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 – and far more managers promise it than have it. I was recently on a panel that was asked what gave our firms their edge. One panelist responded "we have 160 analysts around the world." To me, that response demonstrated a total lack of insight. Unless those 160 analysts are more astute than the average investor, they'll contribute nothing. Certainly another 160 wouldn't double the manager's ability to add value. (If they could, everyone would be an analyst.)

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 which 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.

Indexed equities – Thirty years or so ago, investors began to concede that while it was desirable to participate in the stock market, it wasn't worth trying to beat it. Under prodding from academics at the University of Chicago and practitioners such as John Bogle of Vanguard, there began a trend toward index funds, with their low costs and assured inability to underperform.

The essence of index investing was a "passive portfolio" that represented a relatively unbiased sample of the universe of stocks. The Standard and Poors' 500 was the immediate choice and quickly became synonymous with "stocks" and "the market."

With every period in which active managers underperformed, the trend toward indexing got another boost. The percentage of equities held via index funds rose. In the mid-to-late 1990s, when large-cap growth stocks hogged the spotlight, passive investing outperformed. (That's an oxymoron, isn't it?) But as the groups most heavily represented in the S&P did best, indexation was in fact looked at as an offensive weapon.

As the tech stock boom reached its apex in 1999, even the keepers of the S&P 500 succumbed to the trend. In order to stay "modern" and "representative," they threw out low-priced Old Economy stocks that had lagged and substituted hot tech names such as Yahoo!, Broadcom, JDS Uniphase and Palm. The effect – the error – was classic.

Adding a fast-rising tech stock to the S&P made index funds buy it, as well as active managers measured against the S&P. This added further to the stock's momentum, in a self-fulfilling cycle.

By the end of 1999, technology stocks constituted roughly 40% of the S&P, and thus it no longer delivered "unbiased" participation in equities. Prudent index investors looked for alternatives like the Russell 5000, while trend-followers threw more and more money into the S&P. As usual, investors got carried away with the simplistic solution; in some people's minds, index funds' infallibility was transmuted from "incapable of failing to capture the gains of stocks" into "incapable of performing poorly." Of course, money flooded in.

The cycle turned, as it inevitably does. The recently added tech stocks hurt the S&P in 2000, and indexers underperformed active managers. On March 30, 2001, The Wall Street Journal wrote: "For investors with index-fund holdings, the market downturn makes the forget-about-it approach a much less appealing strategy than when stocks are climbing." As the kids say, "Duh!"

Stocks of great companies – Over the years, buying and holding the stocks of leading companies has been a favorite way to strive for high return and low risk. In 1999 I heard lots of people say they were buying Microsoft, Intel and Cisco because they were sure to lead the technology miracle. They still are, and yet their stocks are now down 53%, 68% and 83%, respectively, from their highs.

People too easily forget that in determining the outcome of an investment, what you buy is no more important than the price you pay for it. As Oaktree consistently demonstrates, we'd much rather buy a so-so asset cheap than a great asset dear.

The stocks of great companies often sell at prices that assume their greatness can be perpetuated, and usually it cannot. While in business school in the 1960s, I read a brochure from Merrill Lynch introducing a novel concept called growth stock investing. Many of the stocks it profiled went on to be pillars of the Nifty-Fifty by the time I joined the First National City Bank in 1969. It was the party line that if the company you invest in is good enough and growing fast enough, there's no such thing as too high a price. Along with lots of companies that are still considered great, the Nifty-Fifty included such average companies of today as Avon, Kodak and Polaroid. Starting from their 1973 highs, we estimate these stocks' respective annual returns at .4%, (.4%) and (10.4%)! **"Great company today" doesn't mean "great company tomorrow," and it certainly doesn't mean "great investment."**

On February 7, 2001, the Wall Street Journal carried "Unsafe Harbors: Folks Who Like To Buy A Stock and Forget It Face Rude Awakening." It said,

Big, industry-leading companies are being rocked by everything from deregulation to cutthroat competition to fast-changing technology that can shift an industry's balance overnight. The speed of change today is changing the concept

of a few safe stocks, which you can just buy and sock away, into almost an investment relic.

The Journal supplied lots of evidence showing how risky it can be to buy and hold stocks thought to be great:

- Among the 50 largest stocks in the S&P 500, almost half lost 20% of their value last year; . . . even in 1999's bull market 10 of these top 50 stocks fell by that much.
- Ten of the 50 biggest stocks lost 20% in a single day last year.
- In each of the past three years, an average of eight of the 50 stocks in the S&P 500 sporting the highest dividend [yields] dropped 20% or more in a month.

A February 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. Can you guess the only company that did it in all three periods? It was Philip Morris. And yet despite that unequalled record, its stock rose only 7.6% per year in 1991-99, (13.0% per year behind the S&P 500), because of concern over tobacco litigation.

Pursuing quality regardless of price is, in my opinion, one of the riskiest – rather than the safest – of investment approaches. Highly respected companies invariably fall to earth. When investors' hopes are dashed, the impact on price is severe. For example, if a high p/e ratio is attached to earnings that are expected to grow rapidly, an earnings shortfall will cause the p/e ratio to be reduced, bringing about a double-barreled price decline.

Lord Keynes wrote "speculators accept risks of which they are aware; investors accept risks of which they are unaware." As Keynes's definition makes clear, investing in the stocks of great companies that "everyone" likes at prices fully reflective of greatness is enormously risky. We'd rather buy assets that people think little of; the surprises are much more likely to be favorable, and thus to produce gains. No, great companies are not synonymous with great investments . . . or even safe ones.

High-grade bonds – After several years in investment exile, traditional fixed income instruments racked up good absolute returns and super relative returns in 2000. (For example, the Lehman Brothers Government/Credit Index was up 11.9%.) But don't bet on a repeat.

First, I don't believe bonds should be bought with an expectation that their returns will exceed their promised yields. That means 4-6% on governments and 6-8% on high-grade corporates.

Second, government bonds are quite highly priced today, thanks to:

- the flight to quality that resulted from the pain in the stock and high yield bond markets,

- the current low level of inflation, and
- the looming scarcity of Treasury securities as budget surpluses erase the Federal debt (I'm not quite sure I buy that one).

Third, high-grade corporates have not been an unfailing source of safety. The February 7 Journal story referenced above included the observation that "of corporate bonds rated investment grade, an unprecedented 3% fell 30% or more in price last year, according to Merrill Lynch & Co."

The pundits - As usual, the cresting of stocks in 1999/early 2000 was caused and/or accompanied by the vesting of special powers in "experts." I have previously railed against the brokerage house analysts who set price targets based on where they guessed a stock could sell and gave out "buy" ratings to drum up corporate finance business.

The current targets for my wrath are the talking heads from CNBC and its competitors. I resent the role they played in the popularization of equity investing, in the bubble that developed, and in the debacle that followed. They're glad to opine on what stocks are worth, why they went up or down yesterday, and what they're going to do tomorrow. But the more I listen, the more I feel the absence of a few key phrases like "beats the heck out of me" and "darned if I know." I think one of the elements that roped in so many people and convinced them they could invest safely despite their lack of expertise was the media's repeated message that these things were knowable. Some of the confidence of these personalities has evaporated of late.

The Fed – The trend of personalizing described above reached its apogee in the deification of Alan Greenspan. For almost fourteen years, Greenspan has done an excellent job at the Fed. He kept a weather eye out for signs of inflation and took steps to avert it when needed. He wisely injected liquidity into the financial system in times of crisis. And he made every effort to keep a steady hand on the economy, trying to avoid sudden moves that could unsettle the participants.

He has presided over a terrific economy; I can't imagine a better one. I phrase that carefully, because it will be debated whether he made it great or it made him great. People who know things I don't will decide the question.

In January, the markets demonstrated their great faith in Greenspan by leaping forward when the first interest rate cut was announced. "Surely Greenspan will be able to avoid a cessation of growth." Investors were highly confident that he would be able to save them. Yet in 1998-9, when he as good as said "I'm going to slow the economy and rein in this irrational exuberance," no one acted as if he could, and the market continued to roar.

That is, investors first disregarded his power to throw cold water on the party but later had great faith that he could keep it going. I think this demonstrates their lack of objectivity and the selectiveness of their perception. No one can build the perpetual motion machine investors hope for, but that doesn't mean they'll stop hoping.

The sure thing – In fact, that brings me to the bottom line. Even though people have always looked for the silver bullet, the easy answer and the free lunch, there is no such thing. "Hope springs eternal," they say, or is it greed? Everyone wants the riskless route to riches, but markets exist to make sure it can't exist for long.

No one has all the answers. Lots of people can guess the direction of the market once or twice, or pick the right stock or group, but very few can do it consistently. That doesn't keep investors from following the latest Messiah who's been right once in a row. But no one seems to ask "if he knows what's going to happen, why is he telling me?"

No rule is valid all the time. Buy growth; buy value. Buy large-cap; buy small-cap. Buy domestic; buy international. Buy developed; buy emerging. Buy momentum; buy weakness. Buy consumer; buy tech. I've seen them all.

There is no perfect strategy. People flocked in droves to growth stock investing, real estate, portfolio insurance, Japanese stocks, emerging market stocks, tech stocks, dot-coms and venture capital. Each worked for a while and sucked in more and more investors. But in each case, success eventually pulled in enough money to guarantee failure.

Over the years, performance has constantly improved in areas like golf. That's because while the participants develop new tools and techniques, the ball never adjusts and the course doesn't fight back. But investing is dynamic, and the playing field is changing all the time. The actions of other investors will affect the return on your strategy. Just as nature abhors a vacuum, markets act to eliminate an excessive return.

So Then What Do We Do Now?

I have a few things to suggest that may help in the years that lie ahead. None of them will prove easy to implement, however. None will give you that sure thing.

Accept change – Among the important elements that clients, consultants and managers must possess is adaptability. The only thing you can count on is change. Even if the fundamental environment were to remain unchanged – which it won't – risk/return prospects would change because (a) investors will move the prices of assets, certainly in relative terms, and (b) investor psychology will change. That's why no strategy, tactic or opinion will work forever. It's also why we have to work with cycles rather than ignore or fight them.

Search for alpha – In doing so, however, it's essential to understand:

- what alpha is,
- what markets permit it, and
- who has it.

To me, **alpha is skill**. It's the ability to profit 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.

More important, **alpha is differential advantage**; it's skill that others don't possess. That's why knowing something isn't alpha. If everyone else knows it, that bit of knowledge gives you no advantage.

Lastly, **alpha is entirely personal**. It's 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. But all those I've met are extremely hard working.

You want managers who have alpha, and you want them to be working in markets that permit it to be put to work. Only in markets that are not efficient can hard work and skill pay off in consistently superior risk-adjusted returns. I always say if you gave me 20 Ph.D.s and a \$100 million budget, I still couldn't predict the coin-toss before NFL games. That's because it's something into which no one can gain superior insight. When someone says "my market is inefficient" or "I have alpha," make him prove it.

You want to be sure the claimed alpha is there. Just about everyone in this business is intelligent and articulate. It's not easy to tell the ones with alpha from the others. Track record can help but (a) it has to be a long one and (b) it's still possible to play games.

My advice to you is that when you find managers who do what they promise and seem to do it well, stick with them. Even the best manager won't be infallible, but staying with those who've demonstrated skill and reliability will reduce the probability of disappointment. I don't expect much out of market returns in the years ahead, so alpha will be more important than it was in the 1990s.

Pursue non-market-based returns – 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 with a return on the S&P 500 worse than minus 4.8%. From 1978 through 1999, the return on the S&P 500 averaged 17.6% per year. It 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.

The observers I most respect foresee single digit returns. Stock market 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. Returns like that would be somewhat below the historic average, but after such a great 22-year period, a little correction wouldn't be unreasonable.

So if stocks are poised for unexciting single-digit returns, (and if the period ahead may be marked by more negative surprises than the recent past, which I believe), what looks promising? I suggest you search for returns that are not predicated on market advances.

Coupon interest provides a good start, so high yield bonds and convertibles are likely candidates. Distressed debt is an example of a non-prosperity-oriented strategy that should work well.

Lastly, I would take a good look at "absolute return-type" strategies. These are designed to systematically take advantage of market inefficiencies and to capture managers' alpha while limiting susceptibility to 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 to the performance of the mainstream markets.

I think investors are about to move into these areas en masse for a number of reasons:

- because they did well in recent years, and especially well amid the chaos of 2000,
- because of the pain inflicted by stocks over the last twelve months, and
- because of the modest prospects in the mainstream markets.

I expect hedge funds and absolute return funds to be promoted heavily by brokerage firms, mutual fund organizations and investment advisers and to become the next investment fad. And there's good reason why they should. Especially given the competition from the mainstream, an appropriate mantra for the 2000s might be "low double digits ain't bad." If you can identify managers who possess enough alpha 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 managers get a share of the profits.

However, that doesn't mean a few caveats aren't in order:

- **Expectations must be reasonable.** Investors must realize that very few managers are truly capable of earning 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" and "market neutral" funds drop precipitously. That's because it's unusual for portfolio returns to be entirely divorced from their environment. For example, one of the things currently attracting attention is the excellent performance of risk arbitrage last year. But something systematically favorable may have occurred in 2000, and thus it could turn systematically unfavorable in some future year. I've often said "zero correlation" may not be 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, put more dollars into each position, put on a larger number of positions, broaden the fund's range of activities, add new staff members

and/or reduce selectivity. All of these can have negative implications. George Soros and Julian Robertson had terrific records, but they eventually reached \$20 billion and lost their specialness.

Second, many of the best managers with alpha 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 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 was theirs). Thus, as the amount of money in the area rises, the average quality of the managers may fall.
- **Fees can eat up alpha.** 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 managers built successful hedge funds on 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.

Investment trends certainly run the risk of being carried to extremes. (For an 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. No process, no label, no strategy will deliver performance in and of itself. Exceptional low-risk performance requires a partnership between skillful, disciplined money managers and insightful, hard-working clients.

April 10, 2001

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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 Conseco 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

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Memo to: Oaktree Clients
From: Howard Marks
Re: Notes from New York

Maybe you've already read enough about last week's events, in which case you should feel free to discard this memo. There is no moral obligation to keep reading when doing so brings pain. Each of us can decide when enough is enough.

By now most of us know all we need to about Tuesday's events at the World Trade Center and the Pentagon. I will not recount the facts relating to these events, but rather the thoughts they have left me with.

I spent Tuesday through Friday in New York – like so many, against my will. I had no plans for a memo on this subject. But when I woke up Saturday, at home for the first time in a week, thoughts of New York monopolized my mind. My way of dealing with them is to turn them into sentences and paragraphs.

This memo may not include much that is new to you but, as usual, I will attempt to pull together my own thoughts and what I've heard and read elsewhere. It won't touch on recommendations for investing or predictions for economies and markets. Its contents will range from trivial descriptions of New York after the attack to hopefully-meaningful observations on the big-picture ramifications that have been seen and that may follow.

Lastly, I certainly do not wish to write anything that offends. But nerves are frayed, and unintended offense might be taken, for which I apologize. I mean only the best, and I hope it comes out that way.

My Role – I was merely a bystander at the events of last week. I was affected emotionally and logistically, but not involved. My father and daughter, both of whom live in New York, were safe. I had no friends or colleagues at the World Trade Center. As for me, I had arrived at midnight Monday after a dinner in Cleveland. I planned to speak to a Pensions East forum on Tuesday morning and then fly to Berlin to participate in an Institutional Investor conference.

The Events – The crashing of planes into the WTC and the Pentagon represented the first large-scale foreign attack on continental United States soil. It was daring, well planned, coordinated and startlingly successful. It showed how the fruits of progress – the world's great airliners – can be used against us. It showed how, in this age, a handful of men from a smallish, amorphous enemy can cause destruction totally disproportionate to their number or materiel.

I was struck by a New York Times article saying these terrorists are not insane. They are extremists who follow a dogma that most Muslims do not. They are highly indoctrinated and perhaps brainwashed. But they are intelligent, highly trained soldiers who will carry out orders to destroy what they believe is their enemy. We count on others to act in their own self-interest; this makes them predictable and helps us know how to deal with them. It is not there in the case of the terrorists, in that they care little about their own survival. This adds greatly to the danger they pose.

Reaction – I left Oaktree's New York office Tuesday afternoon to collect my daughter and the children of friends in a natural desire to assure safety and feel the sorely-missed ability to create order. I walked north through streets that were strangely normal but not quite. The tourists were there, with their cameras and maps. There was no smoke and no ash. There were a few more people than usual, and almost all were moving in one direction: north, away from the WTC. There was no screaming or crying, no running or panic, just occasional knots of people gathered around radios.

Only knowledgeable onlookers would have detected the differences. Few people were talking. Eyes didn't meet – which is not unusual in New York. There clearly were no smiles. The words that came to mind were "subdued," "somber" and "enervated," and they stayed with me all week. Stress and tension were everywhere.

Some things were very different, and some that were the same felt different. The absence of airliners overhead was obvious, and the effect was dramatic when fighter jets replaced them. Sirens were heard more clearly in the absence of competing noise, and they seemed more ominous – as was the case in Los Angeles during the riots and earthquakes.

Pedestrian and vehicular traffic was light the first night, and it grew only gradually. Grocery stores were crowded; sidewalk restaurants were populated; it was clear life would go on.

Each of us found his or her individual limit on how much we wanted to read, watch and talk about these events. At the same time, however, it seemed inappropriate to talk about or do anything else. In my limited sample, the kids found it easier to move on to other topics – and I was so glad to see that their lives, albeit probably changed forever, would rebound.

Communication – My cell phone and Blackberry wireless e-mail device were absolutely essential. I was again reminded to ask "How did we ever get along without these things?" It was very hard to make phone calls on Tuesday, but that, too, got a little better each day. My Blackberry always worked and made it possible for me to keep in contact with my Oaktree colleagues.

Spam e-mail was absent that first day, but it also came back. Resumes, start-up business proposals and offerings of money management firms for sale seemed incredibly inappropriate on the one hand, but I guess they, too, are part of the return to normalcy.

Retaliation – Armed response was, of course, one of the first issues to arise after the crashes. The President promised it Tuesday evening, and it is on the minds of us all. But no one should underestimate the challenges involved. The terrorists are amorphous, as I said, and pervasive. They exist everywhere but have no headquarters. They are dedicated but wear no uniform and fly no flag. They will not be easy to find or deal with. In the past we believed in the invincibility of the U.S., and thus in our ability to root out evil and prevail. There is still positive evidence on this subject, but also evidence to the contrary.

The Gulf War was one of our swiftest and most decisive triumphs. We were also able to calm the hostilities in the Balkans. On the other hand, Vietnam showed how hard it is to deal with a guerilla enemy who melts into the scenery, and last week's events strongly call into question the efficacy of our intelligence effort.

The nations of the world – even most of those in Middle East – have been quick to express horror and swear their support of the U.S. How many mean it, and how many have done it falsely to avoid our wrath? I certainly hope it's the former.

The swiftness and forcefulness of our response will depend to a great deal on how willing we are to diverge from some American ideals, and thus will require some difficult decisions. How sure will we have to be before we take action? Will we accept the risk of losing world support if we make mistakes? Are we willing to kill non-combatants? Are we willing to bear casualties among our own servicemen and women?

Centuries of immunity from attack on our soil, and decades of relative safety in a world in turmoil, have allowed Americans to enjoy the luxuries of moral certitude, personal freedom and safety. With our apparent wall of invulnerability penetrated, we will have to debate the extent to which these luxuries will be dispensed with.

Our Tactics – There is bound to be review and debate regarding the tactics we will employ in pursuit of safety and justice. In the recent past, there has been a rise in the position I paraphrase as "we will do no evil, even in the interest of doing good." Thus it was decided that the CIA would not perform assassinations or employ "intelligence assets" with records of crimes or human rights violations.

These principled stances may come to be viewed as luxuries we can no longer afford. When prosecutors obtain cooperating testimony, it is usually from criminals – because that's who the targets of prosecution associate with, and that's who can be turned against them. It is now clear that we need intelligence regarding upcoming terrorist operations, and that intelligence must come from inside terrorist cells. People we might not wish to associate with – perhaps only terrorists themselves – can best gain that access. They may be the ones most able to penetrate the obstacles posed by language and the close-knit nature of the cells. Can we afford not to employ them?

Civil Liberties and Scapegoating – These events and their aftermath may make us conclude that full civil liberties and full domestic security may be mutually exclusive.

Over the last eight years, Mayor Giuliani cut New York's murder rate by two-thirds using tactics that eroded civil liberties in high-crime areas. People were stopped and frisked on the street, and there were roving squads of undercover policemen – including those who mistakenly killed Amadou Diallo. Giuliani was assailed as a fascist, especially by the high-minded New York Times. But I detected two common threads last week: "his emergency preparations were appropriate, not excessive," and "he's the kind of mayor we'll need in the years ahead."

Depending on how far and in what ways the terrorist campaign spreads, we might begin to see armed personnel where people gather. And they might need to be able to search those they suspect. We may see surveillance cameras, computer facial and fingerprint recognition and the use of profiling. Internet and telephone privacy may be abridged. Travel will be less convenient, and our borders may be made less porous. These subjects are likely to be hotly debated, but the debate is certain to be conducted from a new perspective. **And I think the answers are likely to be different from what they would have been a week ago.**

One of my reflexes on Tuesday was to think about a recent movie, "The Siege." In it, a New York police detective tries to cope with a Muslim reign of terror in New York. At the same time, members of an outraged populace pursue vigilante justice against Middle Easterners, and the President sends in the army, led by an all-business general. He declares martial law, suspends civil liberties and rounds up New Yorkers based on ethnicity. It's not a great movie, but it is as relevant as "Wag the Dog" was to Bill Clinton's impeachment-eve bombing raids. You'll be glad to know it ends with the threat defused and American ideals preserved.

There will be – already has been – violence against Americans of Middle Eastern origin. But know this: **People say that if we let stocks fall, if we don't rebuild the Towers, or if we don't return to normalcy, then our enemies will have won. All of this is true, but if the events of the week are able to turn Americans against Americans and erode the values that have made this country great, they also will have won.**

Hysteria and Miscommunication – I witnessed, first-hand, the ability of emotion and fragmentary information to combine for error. On Thursday afternoon, I heard that three or four men in pilots' uniforms had been stopped trying to board planes. By early evening it had grown to seven. But on Friday it turned out to have been one.

I actually listened as the existence of a recent government report on terrorism was interwoven with thoughts that it might be unsafe for President Bush to visit New York, as well as a few other elements, to support a warning that chemical or biological weapons would be unleashed on Friday. Hysteria is natural in crises, but hopefully it will subside – while hopefully vigilance will remain.

Heroism – As Dickens suggested, the worst of times can bring out the best. I am incredibly moved by the accounts of people in careers based on bearing risk to help others, and of everyday people who rose to great heights.

Friday's Wall Street Journal carried an incredible, eloquent tribute to the bravery of New York's firemen. It said "**In the academy, recruits learn that a firefighter performs but one act of bravery in his career, and that's when he takes the oath of office. Everything after that, it is said, is simply in the line of duty.**" I cannot read this without being moved profoundly.

Last week proved that America is rich in heroes: The man who carried a woman he didn't know down fifty flights of WTC stairs. The people who drove hundreds of miles to offer their services in the rescue and cleanup effort. And the ultimate heroes, the passengers who crashed United flight 93 in Pennsylvania rather than let it be used as another terrible bomb. Who among us could crash the plane we're on to save hundreds or thousands of strangers?

Loss – As I wrote last week, Oaktree was fortunate in having no losses. Teresa O'Hagan's husband and his four brothers are New York firemen; some were missing or incommunicado for periods of time, but all turned up safe. I lost it when I spoke with her and felt the emotion flowing through both of us. Noreen Keegan and Zenobia Walji have husbands who are policemen, and they, too, are fine. It took a while longer, but Eric Livingstone's girlfriend and Nilsa Veras's mother also proved to be safe.

Most of us, however, knew someone who was not as lucky, and that brings it home. For me it was David Alger, head of Fred Alger Management Inc., with whom I shared a podium in March. I have read only good things about him.

These events clearly prove that "random violence" does not mean "spread evenly." I am struck by the incredible pockets of loss. Some WTC tenant firms had no losses, but Cantor Fitzgerald and Fred Alger lost huge percentages of their employees. More than 300 New York firemen are missing and presumed dead, including entire fire companies.

Oaktree's Kevin Clayton lives in an area from which many people commute to lower Manhattan. Thus ten people are missing from his parish, and well more than 100 from the nexus of towns that includes his. The loss of thousands of people in a few minutes – and the localized, concentrated losses – are things I hope never to live through again.

The Results – They say every cloud has a silver lining, but it's hard to see the good in this one. The tales of heroism and sacrifice have been wonderful, but I'd rather not have had occasion to read them.

At the same time, and equally incredibly, these events have brought the worst of Americans out from under their rocks. I am sickened to hear of the copycat bomb scares, phone calls designed to pry the social security numbers of the missing from their grieving families, and phony contribution scams.

The loss of life has been massive. The financial cost – to rebuild New York and the Pentagon, to the airlines, for stepped-up security, and for business lost – will be enormous.

The wonderful feeling that the U.S. was insulated and impregnable has been breached. The vulnerability to attack of our everyday life has been made clear. Life here may never seem as carefree. Last week I told my son Andrew that, incredibly, the Berlin conference was still going on as usual. He said "What's so incredible? Each time there's been a bombing somewhere in the world, life here has gone on without skipping a beat." In many ways, we now have been dragged into a reality that is commonplace throughout the world – which may well have been one of the terrorists' objectives.

Last week's events proved that money, position and technology are not the most powerful or important things in our lives. **The cornerstones of our lives were shown to be family, faith and principle, friends and colleagues we know we can count on, and the American spirit. These are the things we have to be thankful for . . . maybe now, we realize, more than ever.**

September 16, 2001

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Memo to: Oaktree Clients
From: Howard Marks
Re: What Lies Ahead?

Writing my client memos gives me great satisfaction. I appreciate the opportunities to share my views with you as well as your receptivity to them. Setting down my "Notes from New York" did me a lot of good as my way of dealing with post-attack issues outside the investment arena.

I must admit that I haven't been looking forward to writing a memo about the economic and investment implications of the attacks. Many of my views are negative, and I'm no economist. But I want to give you the benefit of my thinking, such as it is.

Looking to the Future – All of economics, business and investing entails dealing with the future. Economists predict future conditions. Businesspeople build and manage organizations so as to profit in the coming environment. And, of course, investors try to figure out what things will come to be worth in the years ahead and act accordingly. Other professions deal more with the past (e.g., accountants and historians) or the present (doctors and lawyers), but it is our job to cope with the future.

That's what makes investing interesting, challenging and occasionally lucrative. If it didn't require us to reach conclusions about the future, or if the future wasn't uncertain, then everyone's returns would be the same – but not very high. We achieve high returns on occasion because we deal with an uncertain future, and it's because the future is uncertain that superior investors can get an edge.

The process of investing consists entirely of divining the future – in terms of profits and values – and translating that future into prices that should be paid today. Obviously, doing so requires a view of what the world will look like tomorrow and how businesses and their products will fare in that world.

We each make thousands of judgments a day based on our understanding of what's normal. We turn the right faucet for a drink because that's where the cold water always has been. We tend to buy another car – or another tube of toothpaste – of the same brand because we were happy with the last one. We cross the street on a green light because we trust on-coming drivers to stop on red.

We must make assumptions like these, even though we know they won't hold true all the time. If we had to start from scratch every time we faced a decision, the result would be paralysis. Thus we start by assuming that the things that worked in the past are likely to work in the future, but we also make allowances for the possibility that they won't.

We do the same in our roles as investors. We expect well-managed companies with good products to make money and be valued accordingly. We assume companies that have the money will service their bonds. We count on the economy to recover from slowdowns and grow over time.

So most of our actions depend on extrapolation. Certainly in investing, we rely on forecasts that assume the future will look a lot like the past. And most of the time they're right. My main quibbles with forecasters are two:

1. While most forecasts call for a future that's a lot like the past, the truly valuable forecasts are those that call for radical change. Forecasters rarely make such forecasts, however, and those who do are rarely right.
2. Most forecasters present their work as deserving more credence than it does. In short, they rarely say, "Here's my forecast, and if I were you, I'd take it with a grain of salt."

Even today, forecasters are out there with predictions for the economy and the market that are based primarily on history. And yet it seems to me that the future may be less likely to look like the past than it has until now, and that things we've never even considered before have a chance of happening.

Immediately after the attacks, there began to appear articles citing how long it has taken the market to recover after past crises. But who's to say those precedents are at all relevant? For example, I read that the market sagged for five months after Iraq's invasion of Kuwait but made up all of that ground, and then some, soon thereafter. But that experience had a very favorable outcome. We all want this one to be as good and as quick, but are we willing to bet that it will?

We all want a feeling of assurance. We want to live in a world where the future seems knowable and decisions that extrapolate normalcy can be depended on. We want to believe life in this country will return to the carefree days pre-September 11. We want to believe our leaders will be able to keep the ship upright and manage their way out of problems. So I think we're eager to embrace predictions that these things will hold true. **But is it prudent today in making decisions regarding the future to assume a return to the status quo?**

The New Future – It seems to me that today we know even less about the future than we usually do, and that's never a lot.

1. About terrorism. How much of what we have to worry about stems from Osama bin Laden and al Qaeda, and how much relates to other groups? How much of bin Laden's plans and resources went into the September 11 attacks, and how much remains on tap? Is bin Laden a diabolical genius against whom we're powerless, or a paper tiger who got lucky? Are there additional shoes left to drop? Will there be a high-profile attack once a year? Or will Middle East-style violence

intrude into our regular existence? Are chemical and biological weapons a real threat?

2. About our response. Can we find bin Laden? Can we capture him and his henchmen? Will our military actions be successful, and can they be undertaken without extensive collateral damage? Can we pursue justice without alienating people and nations? Will terrorists move to punish our actions? Will their doing so shake our resolve, or that of our allies?
3. About the economy. How deep a recession are we in for? How long will it last? What will prompt a recovery, and what shape will it take? Will industries like airlines and hotels be permanently depressed, or will they return to pre-9/11 normalcy? When will liquidity and a desire to buy things return? Can we rely on normal cyclical patterns in these things? Will these elements be set back again if there is further terrorism?

Who among us can say he knows the answers to these questions? And who can say the future is foreseeable without those answers?

Many of these questions take us into uncharted territory where no one can say what will happen. The possible answers include some that could profoundly affect the economy and the markets, and they worry me. **Some of the greatest dilemmas in investing surround highly unlikely events with highly negative implications.** It's hard to know what to do about them, but we should at least be aware of their existence.

We have no alternative to assuming that the future will look mostly like the past, but we also must allow for the fact that we face a range of possible futures today that is wider than usual. In other words, I feel we must allow for greater-than-normal uncertainty.

The Role of Confidence – The basic building block underlying all economic activity is the individual spending unit, be it a business or a household. Each of these units builds into its decisions expectations regarding the future. And those expectations are shaped to a great extent by the data, opinions and emotions that add up to **confidence**. Sometimes I think in the economy, confidence is all there is.

When people are confident, they extrapolate prosperity and borrow and buy. They assume an upward-sloping future and want to jump on board. They worry that if they don't buy something today, it'll cost them more tomorrow. That is, they are concerned about the cost of inaction.

When their confidence fades, they worry about losing jobs and defer purchases. They may prefer to build cash or pay down debt. They're willing to wait before buying, and they assume there'll be another chance to buy cheaper. In other words, they figure that if they don't act, they won't miss out on much. Opportunity costs just don't seem that important.

Who would say that confidence wasn't shaken by the events of September 11? Words we would have applied to our domestic security before, like insulated, invulnerable and impregnable, now seem to be out the window. Who doesn't feel at least a little less safe than a month ago? Thus most people are less full of the positive feelings that are required for a purchasing or investing decision, and on average they may "hunker down."

Many economic units have concluded that in this more uncertain world, greater cash reserves are in order – for rational as well as emotional reasons. Individuals fear that jobs will be lost, hiring will be slow, and bonuses and raises will be less generous – and they know they've saved too little and tapped their home equity to keep spending. Home and car purchases will be deferred. Business investment will be slow, especially given that capacity utilization was low and falling even prior to September 11. Each of these decisions will take away a potential source of growth from the economy and contribute to a slowdown. That's what makes for the down-leg of the economic cycle (and we believe one has been well under way for several months).

And when every expenditure that can be delayed has been delayed, the decline will slow and then stop. Then one person will conclude it's not going to get any worse, or prices any lower. One potential buyer will come off the sidelines and place an order; one worker will be hired to fill that order; and one manufacturer will buy a new machine in anticipation of increased business. And one person will decide to buy a share in a business, or even try to start one. And that's what gets the up-leg going.

It's all based on the ebb and flow of psychology. In my opinion, the key question is "How long will it take to restore confidence?" I don't claim to have the answer, but I think it may be a while.

Stimulative Actions – The federal government has acted boldly to combat economic weakness, as it has been doing all year. All economic trends start at the margin, and that's where the government's actions can help. They can keep things from getting as bad as they otherwise would have gotten – but they cannot call the tune.

Immediately providing a record amount of liquidity to the financial system prevented some problems that otherwise would have arisen given the damage to our infrastructure. Difficulties in the movement of funds and settlement of securities transactions were avoided, enabling the system to work and Americans to maintain faith in it. Prompt monetary action worked again to avert a potential crisis, as it did in 1987 and 1998.

Fiscal policy, which relates to taxing and spending, also will have an impact. Government spending is stimulative, in that it uses money to purchase goods or to pay people who may turn around and spend it. Deficits put more money into the economy than they take out in taxes. (This is unlike the surpluses we thought we were heading for, which are restrictive because the government takes out more than it puts back.) In the weeks since the terrorist attacks, the administration has announced programs sufficient to consume the surplus that had been projected for the current fiscal year. These include \$40 billion in emergency funds, \$15 billion in subsidies and loans for the airlines, and

\$60-\$75 billion for "economic revival." In the short run, as CSFB says, this will "create a buffer to the slowdown in activity." (The long-term effects may be less positive, in that deficits and the Treasury borrowing required to support them can lead to inflation, higher interest rates and crowding out of non-government borrowers).

Interest rate reductions also can help ease the contraction, and we may see more of them. They will work at the margin, but I don't expect them to give the economy much of a boost in the short run. One of the most vivid phrases in the business vocabulary is "pushing on a string," and that's what rate reductions can amount to in a hunkered-down world. Will low interest rates get people to buy homes and cars if they've lost their willingness to spend? Will they work with people who realize they have inadequate savings and are overly indebted? Will they cause businesses to invest in expansion if they already have capacity sitting idle?

No one knows the answers to these questions, but they should not be assumed to be overwhelmingly positive. A discouraging analogy can be seen in Japan's decade-long doldrums. The government has pushed interest rates nearly to zero and keeps pumping money into the system. But every time the cautious Japanese citizen gets a few yen he puts it in the bank, and economic growth fails to revive. Hopefully, a difference may lie in Americans' higher propensity to spend.

So in the end, I feel it all goes back to confidence. Consumer and business spending will pick up at some point, and the government can encourage it, but it can't make it happen.

Investor Reaction – On September 17, after a four-day hiatus, the nation's financial markets reopened, with the Dow falling 685 points, or 7%. When I heard about that first day's loss, my reaction was immediate: "That's not so bad – just a quarter of the percentage decline in the crash of 1987." And after declining further in that first week of trading, stocks have recovered most of their losses.

Clearly, the interest rate cuts are helping stock prices. They make investors feel the Fed is doing something to improve the outlook. They contribute to economic activity at the margin. By reducing floating-rate mortgage payments they leave people with more spending money. And by lowering fixed income returns they reduce the competition that comes from cash and bonds, thus making stocks more attractive in relative terms.

But no one knows what the economic future will look like. No one knows what corporate earnings will be in 2001 or 2002, although they appear likely to decline. In addition, geopolitical uncertainties dot the horizon. Thus with the Dow off less than 6% from its September 10 pre-attack close, I wonder whether investors weren't shaken enough, or whether complacency has returned too quickly.

The Dow has risen 10% since the start of the recovery on September 24, including 200+ points this week. The stock market seems to be saying "Well, I'm glad that's over." Frankly, I worry about attitudes like those displayed in an article in yesterday's Wall Street Journal:

Stock Investors Show a "Comfort" Level; Rate Cut Spurs 113.76-Point Rise

. . . the Fed said the Sept. 11 terrorist attacks "have significantly heightened" uncertainty in an already weak economy. Yet despite the Fed's concern, signs are spreading that some professional investors are gradually putting money back into stocks. "The market has reached a level that makes people feel a lot more comfortable that we have seen the worst of what could happen," . . .

I can't tell you how much I hope we've seen the worst, both in terms of world events and in the markets. But I am not willing to bet heavily on that assumption. And if I'm supposed to be more afraid when others are less afraid, articles like this one tell me there's plenty to worry about.

I always stress that investments must leave a substantial margin for error and allow for the possibility that negatives will arise. The terrorist attacks, while certainly not imaginable, show the importance of allowing for adverse surprises. Only when asset prices are clearly at irrationally low levels can this caution be ignored. In my view, with investors' sangfroid having bounced back so strongly, most stocks aren't at such levels.

So What Do We Do Now? – We could assume that the combination of further weakening of the already-weak economy plus continued terrorism will make for a very difficult environment. If we then based our investment process on that assumption, we would hold cash and make very few commitments. I call this "single scenario investing." The problem, obviously, is that arranging our portfolio so that it will succeed under a scenario as negative as that means setting it up to fail under most others. We do not believe in basing our actions on macro-forecasts, as you know, and we certainly don't think we could ever be that right.

Thus Oaktree will continue to invest under the assumption that tomorrow will look a lot like yesterday – an assumption that to date has always proved correct.

At the same time, we will continue to insist on an investment process that anticipates things not always going as planned, and on selections that can succeed under a wide variety of scenarios. As long-term clients know, this part of the story never changes. **In the current environment, we will allow a very substantial margin for error.**

We will continue to work only in inefficient markets, because we feel it's there that low risk needn't mean low returns, and upside potential can coexist with downside protection.

And we will continue to strive for healthy returns in good markets and superior returns in bad markets. We do not promise to beat the markets when they do well, but we also don't think that's an essential part of excellence in investing.

Will I Ever Drop My Cautionary Stance? – On September 24 the Los Angeles Business Journal printed excerpts from an interview with me (and a pretty accurate one

overall) under the title "A Bear's Eye View." Because I wasn't crazy about that title, I was glad soon thereafter to receive the following e-mail from my partner Steve Kaplan:

I have never viewed you as, nor do I believe you are, a pessimist. To the contrary, I think you have an optimistic view when it comes to things you believe you can control. . . . Your caution revolves around the uncontrollable, for which you recognize that a lot of the judgments of the so-called experts are in large part pure guesswork.

I greatly appreciate Steve's comments, and I think – and hope – he got it right. I have no interest in being a pessimist or a bear, and I don't like to think of myself that way. I just may be more impressed by the unknowability of the future than most people. When I reflect on all of the mottoes I use, it seems half of them relate to how little we can know about what lies ahead.

Am I right or wrong in being this cautious? No one can say. Does my mindset, and Oaktree's resultant approach to investing, cost us profits in good years? Probably. Are we well prepared for bad times and untoward developments, and are we happy with that? Absolutely. **If we insist on a degree of defensiveness that turns out to be excessive, the worst consequence should be that your profits will be a little lower than they otherwise might have been. I don't think that's the worst thing in the world.** And in the end, I think the skill, experience and discipline of Oaktree's people will continue to make up for its lower risk profile and keep our long-term returns more than competitive.

The longer I'm in this business, the less I believe in investor agility. Most people seem stuck in positions as bulls, bears or something in between. Most are always aggressive or always defensive. Most either always feel they can see the future or never feel they can see the future. Most always prefer value or always prefer growth. Few people's psyches are flexible enough to allow them to switch from one way of thinking to another, even if they theoretically possessed the needed perspicacity. Rather, most people have a largely fixed style and point of view, and the most they can hope for is skill in implementing it – and I don't exempt Oaktree and myself from that observation.

But that's not so bad. It's my conclusion that if you wait at a bus stop long enough, you're sure to catch your bus, while if you keep wandering all over the bus route, you may miss them all. **So Oaktree will adhere steadfastly to its defensive, risk-conscious philosophy and try to implement it with skill and discipline. We think that's the key to successful long-term investing – especially in today's uncertain environment.**

October 4, 2001

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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

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

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Memo to: Oaktree Clients
From: Howard Marks
Re: Learning From Enron

The investigation was not completed until June . . . The testimony had brought to light a shocking corruption, . . . a widespread repudiation of widespread standards of honesty and fair dealing . . . and a merciless exploitation of the vicious possibilities of intricate corporate chicanery. The public had been deeply aroused by the spectacle of cynical disregard of fiduciary duty . . .

Part of a draft post-mortem for Enron? Could be, but it's not. It's a passage from one of my favorite books, "Wall Street Under Oath." The book was written in 1939 by Ferdinand Pecora, who served as Counsel for the Senate Committee on Banking and Currency investigating the Crash of '29 and went on to become a Justice of the Supreme Court of New York. It recounts the outrageous 1920s conduct of commercial/investment bankers that inspired the creation of the Securities and Exchange Commission and the enactment of securities laws that govern our industry to this day. The bankers' conduct was rife with self-dealing, conflicts of interest and gross dishonesty.

In other words, reviewing the 1920s reminds us of history's tendency to repeat.

What Can We Learn From Enron?

An article about Enron in the December 5 Wall Street Journal made a big impression on me. Headlined "Behind Enron's Fall, a Culture of Operating Outside the Public's View," it read in part as follows:

It was vintage Enron: minimal disclosure of financial information that, in retrospect, was central to understanding the complex company virtually unseen until the end was an Enron culture that contained the seeds of its collapse, a culture of highly questionable financial engineering, misstated earnings and persistent efforts to keep investors in the dark.

Senior Enron executives flouted elementary conflict-of-interest standards. The company hired legions of lawyers and accountants to help it meet the letter of Federal securities laws while trampling on the intent of those laws. It became adept at giving technically correct answers rather than simply honest ones.

The article, and particularly the last sentence quoted above, prompted me to write a year-end memo to Oaktree's staff stressing the importance of taking "the high road" and describing Enron as "a pretty good example of what Oaktree doesn't want to be."

What we knew about Enron in December was a fraction of what we know today. It's now clear that there are many lessons to be learned from it.

Questionable Transactions – Form Over Substance

As little as six months ago, Enron was considered an exemplar of corporate growth and ingenuity. Little did we know, however, that its inventiveness had been directed not at developing highly profitable businesses, but rather transactions that could be used to paint an inaccurate picture of Enron and still squeak by under Generally Accepted Accounting Principles. Some of these transactions were breathtaking in their duplicity and chutzpah.

The most notorious examples relate to the creation of **off-balance sheet partnerships**. These "special-purpose entities" were used to hide debt and pump profits. As our analysts studied Enron, they couldn't believe the lengths to which its management had gone.

When Enron wanted to increase its debt to an extent that would have jeopardized the credit rating that was so essential to its business, it formed partnerships to do the borrowing away from Enron's balance sheet. Off-balance sheet partnerships are common, but for their debt not to be consolidated with that of the parent, outsiders must provide at least 3% of their equity capital. The self-interest of the providers of this risk capital, it is thought, will serve to keep the entities independent.

But Enron had a problem. It wanted to avoid consolidation with its own financial statements, but it feared that vigilance on the part of outside investors would prevent Enron from doing all it wanted in the partnerships. Investors with capital at risk would care about how much debt was taken on, what the partnerships bought with the borrowed money, and at what prices. They might even worry about having Enron executives running the partnerships, which did business with Enron. So outside equity capital had to be attracted to satisfy GAAP, but truly self-interested investors had to be avoided if Enron was to maintain its flexibility.

How could outsiders be enticed to invest capital without caring? Simple: guarantee the results. The key was for Enron, not the investors, to absorb the risk. This is accomplished by promising a full return of capital, and returns up to 30% a year in some cases, and backing the promise with Enron stock. Certainly the security provided by this investment-grade company's soaring stock would be solid. Enron also guaranteed some of the loans to these entities.

So with the "outside" investors' risk covered by Enron and the "independent" partnerships squarely under its control, they could be used any way Enron chose. When assets declined in value, the partnerships would buy them at Enron's cost, hiding the losses. When profits seemed likely to disappoint in a quarter, assets could be sold to the partnerships at inflated prices, covering the shortfall. And with investors insulated from the impact, there was no one to question the prices at which these trades took place and

supply the "arms-length" aspect that would be present in dealings with a truly independent entity.

Less often discussed, but equally questionable, were the transactions that gave Enron **mark-to-market profits**. For example, Enron Energy Services was a highly-touted division that contracted to deliver electricity, gas and energy management services to commercial customers, sometimes for periods of up to a decade. Under mark-to-market accounting, anticipated profits from those contracts were reflected immediately.

Mark-to-market accounting is based on the view that because contracts signed today can greatly influence a company's value, the future profits or losses they imply should be recognized. Based on the terms of the contracts and the likely cost of fulfilling them, management projects the profit that will arise and runs it through the income statement. Obviously, the appropriateness of these profit projections depends on the reasonableness of the cost estimates. If I have agreed to supply gasoline six months from now at \$2 per gallon, you can probably depend on the profits I say I'll make. But the accuracy of profit figures for supplying electricity in 2010 is another story.

Although that technique is standard in commodities trading, problems emerge when there is no liquid market that can establish with a degree of certainty what future market values will be. (Los Angeles Times, February 12, 2002)

At Enron, we're told, the "reliable source" for documenting the future value of contracts – and thus their contribution to the current year's profits – was the company's own models. That's the equivalent of letting ballplayers call the game and keep their own scores.

The last type of transaction I'll discuss are **derivative trades** that made loans look like sales. Again, the amounts of money Enron needed to fund its perpetual motion machine exceeded the amounts that could be borrowed without causing its credit to be downgraded and bringing the motion to a halt. So Enron found a way to enter into "swap" transactions using derivative contracts that in effect were loans but could be accounted for in other ways.

In a normal swap transaction, party A pays party B a premium to exchange one flow of funds for another. For example, if party A holds a floating-rate loan but doesn't want to bear interest rate uncertainty, he might offer party B a fee plus the stream of payments on that loan in exchange for the payments on a hypothetical fixed-rate loan of the same amount and maturity.

In Enron's transactions, a financial institution agreed to accept one stream of payments in exchange for another and then paid Enron the estimated present value of the stream it had agreed to pay over time. Trades like these are called "prepaid swaps," because the financial institution agrees to pay immediately for the stream of future payments to which it becomes entitled. Thus Enron got a lump sum from the financial institution in exchange for the promise of payments in the future.

That sounds like a loan to me. However, Enron's balance sheet told a different story. Because the derivatives related to commodities, the receipts usually were shown as "assets from price risk management" and the payments that it was obliged to make as "liabilities from price risk management." No loan transaction; just money in Enron's till and an obligation to make payments that amounted to interest and principal.

There's nothing wrong *per se* with off-balance sheet partnerships, mark-to-market accounting or swap transactions, or with the standard methods of accounting for them. They're engaged in many times a day, and almost always benignly. The problem arises when these transactions are entered into and accounted for so as to fool, misrepresent and obscure.

Among the common threads running through Enron's financial practices is the fact that (1) they had been designed for uses other than those to which Enron put them, and (2) Enron's accounting for them provided a distorted picture of what was actually going on.

What Was Wrong With Enron's Accounting?

The principal problem was that the transactions represented an effort to use accounting as a weapon against investors, rating agencies, counterparties and regulators.

Although the opponents of gun control like to say that "guns don't kill people; people kill people," I think it's people misusing guns who kill people. By the same token, it's not accounting that creates abuses, but people misusing accounting.

Like most things, transactions like those described above can be abused and misused. At their best they allow companies to accomplish legitimate goals and communicate them clearly. At their worst they can be used to circumvent their normal purposes and avoid apprehension (certainly as in "understanding," but perhaps as in "arrest" as well).

It seems clear that Enron's executives didn't say "What transaction is in the best interest of Enron and its shareholders, and what's the clearest way to account for it?" Rather, they tried to come up with a form of transaction that could be described so as to convey the desired impression – even if the transaction served no valid business purpose for Enron and the accounting for it was misleading.

While failings on the part of its executives, directors and outside auditors certainly contributed, Enron was able to do this in large part because the accounting profession had set out numerical rules that could serve as a roadmap for duplicity, rather than principles that would set standards for the intent and effect of financial reporting. The Wall Street Journal of February 12 explained the distinction:

Auditors who issue clean bills of health are required to certify that a company's financial statements fairly represent the client company's financial performance.

But critics of the accounting profession today say that over the past three decades the standard setters have moved away from establishing broad accounting principles aimed at insuring that companies' financial statements are fairly presented.

Instead, they have moved toward drafting voluminous rules that may shield auditors and companies from legal liability if technically followed in check-box fashion. That can result in companies creating complex structures that technically comply with GAAP but hide billions of dollars of debt or other corporate obligations.

As the Wall Street Journal wrote on February 1 and 8,

... sometimes persnickety rules can become a license for larger dishonesty.

This new environment's two highest values are tolerance and proceduralism. That doesn't encourage good judgment; it suppresses it.

So the lessons regarding accounting are simple:

- **We need accounting standards that are set and enforced in terms of principles, not just technical rules.**
- **Accounting is like any other tool; the results will depend on whose hands it's in.**

The Origins of Corporate Corruption

For those seeking an explanation for fortuitous outcomes, luck has been described as "what happens when preparation meets opportunity." I think Enron inspires a similar explanation for corruption: **it's what happens when exigency meets moral weakness.**

If Oaktree got into a bind, I hope we would admit that performance wasn't measuring up to expectations, that things weren't going our way, or that we simply had made mistakes. I hope we would accept the consequences and try to remedy the situation.

Unfortunately, however, not everyone works that way. Some people are less eager to face the music. If the high road doesn't work out and doing the right thing isn't of great concern, there are people who will cut a few corners or look for a "creative" way out.

I have no reason to believe Enron was formed in 1985 to be the Potemkin village it became, with the intention of misrepresenting results and profiting executives rather than shareholders. And I doubt if anyone said, "Who cares if we hire executives that are morally soft?" I think Ken Lay once had a dream that truly included new ways to profit in a changing energy industry. But when things didn't go according to plan and

maintaining a lofty stock price became a challenging obsession, the people who mattered most either engaged in corrupt practices or failed to blow the whistle on them.

Corporate Rot Can Spread From the Executive Suite

In fact, Enron's culture in recent years seems to have encouraged doing the **wrong** thing. Certainly, the jury is still out regarding Ken Lay. Was he the oblivious dreamer who couldn't understand the details, trusted the wrong people and was duped? Or was he the manipulative master criminal we've heard vilified in Congress?

Whichever was the case, right now we only know the results. It certainly appears that Enron was a company where:

- hubris was encouraged,
- schemers rose to the top,
- people were rewarded for ends, not means, and
- **no one ever asked "but is it right?"**

Whistleblower Sherron Watkins has said that questioning CEO Jeff Skilling about the propriety of the partnerships would have been "job suicide." CFO Andrew Fastow is said to have cursed at the Enron representatives who negotiated against the partnerships he ran and to have tried to get one fired. Lawyers will argue the specifics, and judges and juries will decide, but it seems clear that there were bad guys at Enron, and that nothing in the climate there encouraged doing the right thing.

And encouraging moral behavior, perhaps above all else, is the responsibility of top management. One thing I'm convinced of is that you can't have a great organization without someone at the top setting the tone. The Chairman and CEO can't know everything that goes on in a company, can't be conversant with the details and merits of every transaction, and can't participate in any but the most senior hires. **But they can create a climate where expectations are high and the emphasis is on means, not just ends.**

When I get through telling prospective clients how well my partners manage Oaktree's portfolios, some ask, "Then what do you do?" In addition to communicating with clients and managing the business, I tell them, I try to provide leadership. You can't see it around the office or quantify its effect on the results, but it's what makes a company what it is.

That Depends on the Meaning of the Word "True"

I've seen organizations where, it seemed to me, the standard for truth was that "if something cannot definitively be proved to be a lie, we can say it's the truth." That standard, at best, appears to be what guided Enron.

No one in control at Enron seems to ever to have said "Wait a minute! That's not what's really happening here" or "That description is too unclear to be useful."

Enron appears to have used a very special dictionary. Its key verbs were "mislead," "obfuscate," "manipulate" and "disguise." Its adjectives were "opaque," "Byzantine" and "technically correct." And they had no need for "straightforward," "arms-length" or "candid." Much of the disclosure that did take place seems to have been arranged so that, if need be, Enron executives could say "if you looked in the right place and read it the way we intended, you couldn't say it's not there."

For example, if it was the number of words that counted, this paragraph from a much longer Enron footnote might pass for full disclosure.

In 2000, Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of the transactions, Enron (i) contributed to newly-formed entities (the Entities) assets valued at approximately \$1.2 billion, including \$150 million in Enron notes payable, 3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18.0 million shares of outstanding Enron common stock in March 2003 (subject to certain conditions) and (ii) transferred to the Entities assets valued at approximately \$309 million, including a \$50 million note payable and an investment in an entity that indirectly holds warrants convertible into common stock of an Enron equity method investee. In return, Enron received economic interests in the Entities, \$309 million in notes receivable, of which \$259 million is recorded at Enron's carryover basis of zero, and a special distribution from the Entities in the form of \$1.2 billion in notes receivable, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional derivative instruments. Cash in these Entities of \$172.6 million is invested in Enron demand notes. In addition, Enron paid \$123 million to purchase share-settled options from the Entities on 21.7 million shares of Enron common stock. The Entities paid Enron \$10.7 million to terminate the share-settled options on 14.6 million shares of Enron common stock outstanding. In late 2000, Enron entered into share-settled collar arrangements with the Entities on 15.4 million shares of Enron common stock. Such arrangements will be accounted for as equity transactions when settled.

Could anyone tell what these 260 words meant? There's a lot of ink there, not much information. **Disclosure doesn't mean putting facts out there indecipherably, but rather in a way that lets people discern their significance.**

Obviously, Enron's communication was the opposite of truthful and complete. Equally obviously, Enron didn't want people to know what was going on. Truth was scarce at Enron, and something to be toyed with. The examples ranged from ridiculous to extremely serious. We can chuckle at the thought of Enron building a sham trading floor and coaching secretaries on how to sound like traders when analysts walked through. But there's nothing funny about the money people lost because, as the February 4 issue of Business Week reported,

In September, Lay told employees: "Talk up the stock and talk positively about Enron to your family and friends." The company's upcoming financial report, he said, was "looking great."

This was a few weeks after Jeffrey Skilling resigned and Lay was told by Sherron Watkins of her concerns, while he was actively selling his stock, and a few weeks before a \$1.2 billion downward restatement of Enron's net worth.

And it seems old habits die hard. Just a week or so ago, in defending the juxtaposition of negative developments at Enron and Ken Lay's stock sales, a spokesperson pointed out that Lay had bought stock last summer. True as far as it goes, it's my belief that he sold or otherwise disposed of more shares than he bought. It's funny how someone might take "he bought stock" to mean, "he bought stock on balance." To paraphrase a former world leader, it all depends on the meaning of the word "true."

The acid test for the truth is really quite simple: If everyone got a chance to knowledgeably compare reality against what we say about it, what would they think? Enron wouldn't have done very well under that standard.

Conflicts of Interest

It's an old-fashioned question, but one that seems to have been forgotten at Enron: **Whose interests come first?**

Each of us encounters this question daily, having to balance the interests of others against our own. Should I slow down for the driver signaling to change lanes? Can I take the last piece on the platter? The biggest one? If I'm late for a flight, is it okay to push through the security line? Is it fair to just pick out the cashews and almonds, or must I eat my share of filberts and peanuts too? Is it okay to break a date when a better offer comes along?

These decisions aren't easy. Rabbi Hillel described the dilemma two thousand years ago: "If I am not for myself, who will be? And if I am not for others, what am I?" Despite the difficulty, most of us were taught by our parents to do a decent job of balancing self-interest and the interests of others.

For people in positions as fiduciaries, the law makes it a lot simpler: the other guy comes first. It's obvious that an executor can't buy assets from the estate at bargain prices. Likewise, company managers and directors owe their first loyalty to shareholders, pension plan beneficiaries and, in insolvency, to creditors.

Like the test for truth, the test on handling conflicts seems pretty simple: **If everything we do ends up in the headlines, will anyone have grounds for complaint?** Well, no one seems to have applied that test at Enron. It all made it to the headlines, and Enron flopped.

The most egregious instance involves executives like Chief Financial Officer Andrew Fastow and Managing Director Michael Kopper who (1) set up off-balance sheet entities that did business with Enron, (2) assumed control of those entities, (3) negotiated on

behalf of the entities with Enron subordinates whose compensation they determined, and (4) profited fabulously. Fastow is famous for having made \$30 million from the entities, and Kopper made at least \$10 million. Given that the partnerships are generally not believed to have served valid business purposes, those profits represent a direct transfer from Enron's coffers to those of the employees for which Enron received no legitimate *quid pro quo*.

By the way, Enron had an ethics policy, and it probably would have prohibited these things. So the directors voted to waive the policy. But that vote didn't make the actions right.

Neither was it a good idea for Ken Lay's sister to be Enron's travel agent, or for Enron to contract with and invest in companies owned by Lay and his son. Each of these might have had a valid business purpose. **But it's essential to avoid both conflicts and the appearance of conflicts.** We all might like to use employer dollars to benefit our relatives, our friends, and even ourselves, but the temptation must be resisted. If top executives engage in transactions that suggest self-dealing, even if they might be capable of tortuous rationalization, it makes a statement that fiduciary duty and moral behavior are dispensable. What could be worse?

In the business world, potential conflicts of interest arise all the time. We can't avoid them, but our goal must be to deal with them honorably. Clients, shareholders and others who depend on us must come first.

Whose Company Is It, Anyway?

When a public company is involved, an important question is whether management acts like the company belongs to them or to the shareholders.

As part of my business education I learned that America's commercial progress took a big step forward when management was separated from ownership. About a century ago, companies began to be turned over to hired managers. Because company owners aren't necessarily the best managers, it followed that the emergence of a professional manager class would, on balance, enhance the quality of management.

This made great sense to me. Certainly this separation is one of the things that made America the world leader in business. But now I think it has gone too far in some cases. Alan Greenspan said recently, "There has been a severance, in my judgment, of the interests of the chief executive officer in many corporations from those of the shareholders, and that should be pulled together." (Los Angeles Times, February 28, 2002)

Enron's managers didn't act like paid caretakers of other people's company, but rather as if they owned it. Of course, Ken Lay *et al.* would argue that everything they did was done to create value for the shareholders. But is there any reason to believe they acted the way the shareholders would have wanted them to act? Certainly they can't

argue that they had the shareholders' blessing, given that they never let on what they were really doing.

Of course, executives defend their actions by invoking the cloak of shareholder governance: that shareholders elect the directors, and it's the directors who choose and direct the CEO. We've seen hundreds of times, however, how hard it is for the company-proposed slate of directors to lose an election or for a dissident proposal to be passed.

Acting in the interests of shareholders is just one option for management today, and clearly it wasn't the one chosen at Enron.

Aligning Interests

About a decade ago, Forbes published a special issue on executive compensation. In it, a sage, experienced director said of managers, "I've given up on getting them to do what I tell them to do; they do what I pay them to do." I've never forgotten that statement.

When individual compensation gets into the tens or even hundreds of millions of dollars per year (including stock and options), managers profit as if they owned the company and took the risk. They appropriate a major share of profits for themselves in the good years, even though they lose nothing (other than perhaps potential or previously-accrued profits) in the bad ones.

Set up this way, management has lots of incentive to take risk and cut corners. It sure worked that way at Enron. The executives can point out that the board approved the key elements in the compensation program. But once again, I say the board's control over management is limited.

Options have played a major part in the trend toward outsized compensation. Early on, when their use began, it was felt that options would align the interests of management with those of the shareholders by (1) interesting management in how the stock did, and (2) tying compensation to the company's long-term performance.

As with so many things, however, the negatives have been found out through experience:

- Options focus attention on short-term performance, not long-term.
- Options focus attention on the performance of the stock, not the company (and those are two very different things).
- Options give management a skewed interest in the company. It was thought that they would make managers into stockholders, but this is rarely the case. Employees usually sell very soon after exercising, often simultaneously. This is because they either don't have enough capital to hold or don't want to bear the downside risk. Thus executives profit from share appreciation but rarely hold shares. That's very different from the lot of the company's owners.

- Because the cost of option programs never shows up in the income statement, their cost is considered in a distorted way. Option grants amount to giving a portion of the company to the employees, but no net income effect is ever seen under current GAAP.
- Stock price declines introduce the unattractive dilemma of option repricing. When a stock falls precipitously, management often proposes a commensurate reduction of the exercise price on options. With shareholders having taken a big loss, it seems unfair to exempt executives from the pain. But it is true that old options that are way out of the money won't serve to retain and motivate employees. And with option grants "free," repricing often is irresistible.

It seems obvious that the option culture, the stock market bubble and the advent of mega-compensation have combined in the worst of cases to encourage short-term fixes and artful – even fraudulent – accounting. I think it's no coincidence that our high yield bond portfolios encountered two examples of accounting fraud in February 2001 alone, more than in the previous twenty years put together.

Moving away from the subject of options, the New York Times of March 1 indicated another way in which compensation incentives can be counterproductive. Early in 2001, the Times reported, Enron executives and other employees received hundreds of millions of dollars in bonuses tied to earnings and stock price performance.

. . . executives received large bonuses . . . with the amount based in large part on the earnings of the company – figures that investigators for a special committee of the Enron board have concluded were inappropriately inflated by company executives . . .

Legal experts said that the payments could provide strong evidence of a motive for the financial machinations that investigators think distorted the company's reported performance and ultimately led to its demise. Without those efforts, the profits and stock price levels required to obtain the money certainly would not have been reached . . .

Almost every decision that ultimately led to the company's collapse – including the establishment of a series of partnerships . . . which an investigating committee of the board concluded were used to bolster earnings improperly – was made during the time frame [when the earnings test for bonus purposes was underway] . . .

[According to a former federal prosecutor,] **"The level of compensation that we are talking about here would certainly seem to be a powerful incentive for anyone to do anything."** [Emphasis mine]

Management should be incentivized, but constructively. Excessive, short-term focus on stock price performance is not in shareholders' long-term interest and, in egregious cases like Enron, obviously can bring disastrous results.

I also want to touch on the issue of stock sales by executives. Perhaps because it's an issue with so much visceral appeal, the headlines are full of "Executives Sold While Company Crumbled; Employees and Small Investors Lost Everything."

But I don't think there's anything inherently wrong with executives selling stock. They buy it to profit, and they should be expected to reap that profit at some point in time. If the company and the stock do well, appreciation can create a position too large to hold prudently. So selling's okay; the issue is when.

Clearly, managers mustn't sell when they know things others don't. When that's true is a tough question and often a matter of degree; no shareholder can ever know as much as the CEO does. Selling while saying "the company's doing great" probably isn't a terrific idea – especially if it's not. And the number of shares it's proper to sell probably is a function of the absolute dollar amounts involved and the number of shares retained.

One last note: I have absolutely no sympathy for managers who are renegades, like Enron's seem to have been, but they're not the only ones at fault here. **Every investor who's complaining about the stock sales made by Enron executives could have learned about most of them from government filings and sold alongside. In fact, the onus is on investors who hold or buy while insiders are announcing massive sales.** Investors must accept responsibility for their actions; Enron's faulty transactions might have been covert, but most of the stock sales took place in plain sight.

Where Does the Buck Stop?

While we're on the subject of responsibility, who else should accept it in the case of Enron? (So far I haven't seen many hands going up.)

The little guys are employing **the Nuremberg defense**: "I only did what I was told." And they're right most of the time. It's true they could have objected to what they saw, but that would be asking a lot. The combination of certitude, principles, career alternatives and/or financial resources needed to create a whistleblower occurs only rarely.

Sherron Watkins might be the closest thing thus far, and she certainly did raise red flags in her memo of August. She was brave and stepped forward when few others did, but I'm not ready to canonize her yet. Before I do so, I'll have to get over the large number of references in her memo not to what was right or wrong, but to what might be found out. In August she wrote:

- Skilling's abrupt departure will raise suspicions,
- we will have to pony up Enron stock, and that won't go unnoticed,
- I am incredibly nervous that we will implode in a wave of accounting scandals,
- we are under too much scrutiny and there are probably one or two 'redeployed' employees who know enough about the 'funny' accounting to get us into trouble,
- too many people are looking for a smoking gun,

- we do not have a fact pattern that would look good to the SEC or investors, and
- best case: clean up quietly if possible.

These quotations certainly suggest a preoccupation with perception. Did Watkins truly worry about right and wrong and choose her mode of expression to make an impact on Lay and company? Did she write to complain about wrongdoing or just to push for damage control? And are they two different things or the same?

Unlike the little guys, the top execs are employing what I call **the Geneva defense**: "I was in Switzerland during the war." Nobody ordered the misdeeds or even knew about them. Either they were out of the room or the lights went off. Control freaks with great memories left things to others or can't remember what happened. And, ultimately, they claim the directors and auditors approved everything.

The Role of the Auditors

Why do companies have auditors? So the owners can be sure that (1) they know what management is doing and (2) the financial statements accurately reflect what's going on. As such, auditors play an absolutely essential role in the corporate governance process.

In addition to checking the numbers and opining on the reasonableness of the financial statements, it's their job to tell directors, through the audit committee, when something's amiss. Every audit committee meeting should include some time when no management representatives are present. This is the auditors' chance to tell the directors about things they feel are wrong.

Did Arthur Andersen fulfill its responsibilities at Enron? They say yes and management says no. Surprise!! Certainly, at minimum, the picture is less than ideal.

- First, there's no getting around the fact that Andersen certified financial statements about which no one has a kind word to say. If they had misgivings, they weren't sufficient to make Andersen send up a red flag. We haven't seen any record of Andersen expressing misgiving to the audit committee.
- Andersen received \$52 million in fees from Enron in 2000, less than half of which was for auditing. Auditors' compensation can be so great that keeping the job becomes too high a priority.
- Roughly \$5 million of the total was for Andersen's help in structuring some of the complained-of transactions. When management says, "we'll pay you to think of a creative solution to our problem," there's a lot of incentive to come up with something that accomplishes the company's objectives in terms of effect and optics. And there's little likelihood that the same firm will disapprove it on audit. It's kind of like paying your IRS agent to design a tax shelter.

- Finally, Andersen served Enron for nineteen years, and maybe things got too comfortable. While SEC rules require that the audit partner be rotated, they don't limit the tenure of the firm.

On the other hand, in Andersen's defense:

- It's hard for auditors to know more than management will tell them. (It is their job, however, to tell the audit committee when they don't feel they're getting complete information and to check matters independently where they can.) There's just too much evidence to the contrary for anyone to believe that honest auditors will always sniff out dishonest management.
- All of the details of the financial statements Andersen certified, and of their engagement at Enron, may have met the letter – if not the spirit – of the rules.
- As in any other field, the rotten apple - the dishonest auditor, or even the incompetent one – can do a lot of damage. We don't know yet what the real role of Andersen's David Duncan was in the Enron debacle, but we may find out if he receives immunity as seems to be under discussion.

Auditors are one of the shareholders' last bastions of protection. The Enron example shows us two things: their essential nature and their fallibility. We still need more help.

So Who's Left?

The shareholders' ultimate protection comes from the board of directors. The directors are the representatives of the shareholders and the bosses of the CEO. They are in position to hire and fire, and to approve and disapprove. Sounds like there's no one for them to pass the buck to.

But the truth is, the directors don't work at the company, aren't involved in its day-to-day affairs, and know little that they don't learn from management. I'm a corporate director, and I get my information from management and the auditors (who get much of theirs from management). If they're criminal or uninformed, I'm powerless to protect the shareholders. Bottom line: we can't prevent all fraud and misrepresentation. At best we can discourage it, and at worst we can punish it. We usually assume people are telling the truth, and I would hate to work in a place where I can't.

The contribution of directors can be increased greatly if a few standards are adhered to. The failure to do so may have been one of the major problems at Enron:

First, **independent directors must be independent.** That means they should be aware that they work for the shareholders – not the company or the management – and act like

it. If directors derive unreasonable benefits from the company, they can lose their objectivity, become beholden or grow afraid of losing the job. For just one example in the case of Enron, the chairman of the board's investigating committee testified that all of the directors flew around on company jets. Would they have been willing to give that up to take a stand?

Second, **independent directors have to be hard-working people who will attend meetings diligently, ask tough questions and challenge management.** We're in the process of looking for directors for one of our companies. Someone I asked about a prospect said, "He'll be a pain in the ass to management." Within reason, that's what I want to hear. Relaxed attitudes negate the concept of independence. Directors who serve in perpetuity also should be looked at. After enough years, they can conclude their loyalty is to management.

Third, **at least some of the independent directors must be financially astute enough to fully understand what's going on.** There are valid reasons to include financial novices for knowledge they may have in areas like technology, law or the environment. But there should be enough financial experts to understand management's actions and question them when necessary.

Lastly, **having friends of management as directors can't help the board's independence.** (Although they are the CEO's bosses, directors often get their jobs through the CEO; how's that for a paradox?)

When, for example, you look down the list of the six directors on Enron's audit committee – probably the most important body in terms of protecting the shareholders – you see that at least five fail to satisfy all of these criteria:

- RJ chaired the audit committee for 15 years.
- RC missed more than 25% of the board and committee meetings.
- Enron has given \$1.5 million to the cancer center JM headed.
- JW got an additional \$72,000 a year as a consultant.
- WG's university program received \$50,000 in Enron donations.

Getting highly competent and truly independent directors isn't easy. If the job pays too little, nobody qualified will take it. If it pays too much, independence can be compromised. And if Enron's board is stripped of indemnification and sued, it may become hard for companies to find independent directors at all.

Ultimately, it must be borne in mind that, under the current system, it's tough for shareholders to get boards other than those proposed by management. But as in many of the issues under discussion here, that doesn't mean they should stop pushing for boards that represent their interests.

Don't Expect Much Help From the Analysts

On February 27, the Senate Governmental Affairs Committee held hearings regarding sell-side analysts who covered Enron. Its data showed that as late as November 8, weeks after the SEC had announced its probe of possible irregularities, 10 out of 15 analysts who covered Enron still rated it as a "buy" or "strong buy." (The stock, then around \$9, is now worth roughly zero.) Enron's debt was selling at roughly 60 cents on the dollar at that time. The analysts may have thought the stock was a great buy, but debt investors apparently considered it unlikely that the creditors would be paid – in which case the stock would be worthless.

The analysts told the Senators their failure was attributable to the inaccuracy of the Enron financial statements on which they had relied. Certainly, analysts' starting point has to be the financial statements, and if they're fraudulent, accurate analysis is rendered very difficult. But still, an insightful analyst can call attention to poor earnings quality and inadequate or unclear reporting. In the case of Enron, none of the prominent sell-side analysts seems to have made a peep.

Thus Enron represents another instance, like the dot-coms, where **(a) most benignly, we'd have to say brokerage house analysts possess little insight and their opinions are of no value, and (b) most cynically, it seems they're not there to help investors as much as their companies' investment banking efforts.**

When I started off as an analyst in the 1960s, per-share commissions were high and it was the job of brokerage house analysts to generate them. They accomplished this by providing superior research. (Outright "sell" recommendations were rare nevertheless, perhaps because "buy" recommendations had a much bigger potential audience.) The process through which commissions were whittled down and analysts became driven by investment banking considerations instead built gradually since then.

The truth of the matter is that a hard-nosed analyst with a "sell" recommendation is likely to generate little in the way of commissions but certain to become *persona non grata* and assure that his employer won't get investment banking business from the subject company. Thus, as Sen. Joseph Lieberman said, "These influences compromise an analyst's objectivity and mean that the average investor should take their bottom-line recommendations with at least a grain of salt, if not a whole bucket."

Lack of objectivity isn't the only reason why analysts aren't much help. First, it's hard to develop superior information; in fact, SEC regulations require companies to give everyone the same data at the same time. Second, analysts often develop a closeness with companies and their executives that clouds their objectivity. And third, of course, any insight analysts may have is distributed widely so as to enter the public domain and quickly be reflected in market prices.

My bottom line on research (as you know): the average analyst isn't much help, and only a few are far above average – by definition. If you find an astute and independent

analyst, stick with him (or her). Many sophisticated investors have learned to supplement brokerage house analysis with input from independent research organizations.

Where Does the Buck Stop?

Ours is a free market. **If undeserving (or crooked) companies get capital they shouldn't, the responsibility ultimately falls to the providers of equity capital.** I've read everything I could on Enron, and yet there's almost no mention that shareholders may have been remiss.

Sure, the shareholders were victims of what appears to have been organized and pervasive fraud. But no one can say there weren't warning signs. Shareholders held and bought Enron stock although they couldn't possibly have thought they understood the financial statements, or where the profits came from. They held while the top executives were selling. And they remained unperturbed when the CEO quit without explanation.

And I'm not just talking about individual investors. Al Harrison of Alliance, Enron's biggest holder, has been quoted as saying he bought on "faith." He even admits, "The company seemed to be on a deliberate path not to give full information. Shame on me for not doing something about it." (New York Times, March 3, 2002) Good marks for candor; not so good for due diligence.

I believe many investors underestimate the difficulty of investing, the importance of caution and risk aversion, and the need for their active, skeptical involvement in the process. *Caveat emptor.* Or as they say on TV, "don't try this at home."

Recap, Ramifications and Reform

As Enron's board committee concluded,

The tragic consequences of the related-party transactions and accounting errors were the result of failures at many levels and by many people: a flawed idea, self-enrichment by employees, inadequately designed controls, poor implementation, inattentive oversight, simple (and not-so-simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits. (New York Times, February 3, 2002)

These transactions were just one element in the overall Enron picture, but they typify the malfeasance, laxness, and dereliction of duty that were widespread. I have listed some of the failings that have been laid to executives, accountants, auditors, directors and analysts. Fingers also are being pointed at commercial bankers, investment bankers, rating agencies, lawyers, politicians and regulators. Virtually no one has come away unscathed.

Around the time the Enron disclosures reached their peak, contagion seemed ready to sweep the market. Tyco and other companies with "accounting issues" saw their stocks collapse. Whereas investors generally placed too much faith in companies in the late 1990s, now they have become highly skeptical, perhaps unduly so. As a friend described it, "A few years ago, if management said 'we'll make \$5 billion,' investors swallowed it whole. Today if a CFO says 'we have \$175 million in cash,' investors ask 'how do we know that's true?'"

We've read about the risk of a widespread loss of investor confidence. Allusions have been made to the corrupt practices of the 1920s and the fact that the resulting disillusionment had a lot to do with the stock market's doldrums in the following decade. Arthur Levitt, the last SEC Chairman, testified on Enron that, "What has failed is nothing less than the system for overseeing our capital markets." (Newsweek, February 4, 2002)

As The New York Times wrote on February 10, "The outcome will depend largely on how long the Enron collapse holds the attention of Washington and the public, and on whether once-elevated companies also come to be seen as houses of cards kept standing by financial sleight of hand." The good news is that no epidemic seems to have taken hold. People have been willing thus far to view Enron as an isolated example of management run wild.

That doesn't mean there won't be a spate of regulation and reform. That's what Pecora's disclosures produced, and there's no reason it won't happen again. The Enron story remains telegenic and political, and that makes it grist for Washington's mill. And I certainly don't mean to suggest that some reform isn't needed.

Here are just a few of the ideas that have surfaced (their presence here absolutely does not indicate my endorsement of them):

On the accounting process: regulate "special-purpose entities" and "off-balance sheet partnerships"; require that option grants be an expense against profits; specify broad principles for disclosure, not just technical rules; let the federal government set accounting standards.

On auditors: prohibit or limit non-audit work; make auditor hiring, firing and compensation the province of the board, not management; require increased commentary in auditors' opinion letters; enact term limits for auditing firms; restrict the movement of personnel from audit firm to client; end self-policing by the profession, substituting an outside body; increase "teeth" in disciplinary process regarding auditors; consider restoring civil liability for auditors (and lawyers) who "aided or abetted" a violation of securities law (eliminated by Supreme Court in 1994).

On banks: revive the Glass-Steagall Act separating commercial banking and investment banking (ironically, this law was one of the prime outgrowths of Pecora's investigations, and its key provisions were repealed just over two years ago); require disclosure of contingent liabilities and reserves against them (banks that had committed to lend to

Enron while it was rated investment grade were taken up on their offer when the credit rating collapsed).

On brokerage house analysts: prohibit compensation tied to investment banking business; require disclosure of the derivation of analysts' pay, and of all fees received from the subject company; restrict analysts' trading in recommended stocks; require full disclosure of firms' and analysts' holdings and trading in those stocks; separate brokerage and research activities from investment banking.

On 401 (k) plans: limit investment in company stock; ease restrictions on sales of company stock; require notice before a moratorium on participants' changes goes into effect; improve reporting and participant counseling.

On companies, executives and directors: impose penalties for misleading financial statements; punish carelessness, not just fraud; require increased disclosure, especially regarding transactions with affiliates and insiders; put controls on the use of "creative" accounting concepts such as adjusted pro forma earnings; eliminate personal indemnification in cases of misleading financial statements.

On the SEC: review disclosure regulations; increase power to suspend or bar unethical executives or directors from working at public companies; require quicker, perhaps on-line reporting of insider trades (now not required until month-end), including sales back to the company (now not required until the next year); increase the SEC's budget so that it can hire and retain staff and increase enforcement activity.

On politicians: enact campaign finance reform (it might be on the way); require reporting of lobbyists' contacts; limit lobbyists' role in drafting legislation.

This vast laundry list of possible solutions suggests (a) the magnitude of the problem indicated by Enron and (b) the eagerness of government to ride to the rescue. Some changes will be made, but the belief that the problem isn't widespread should limit their scope.

What's the bottom line, then? The real lessons from Enron, in my opinion, are these:

- As long as there are disclosure rules – and that's forever – there'll be "technically correct" statements that leave investors in the dark. In order to get numbers with integrity, you need people with integrity.
- Rules are just the first building block in creating a safe market. We also need compliance and enforcement, neither of which will ever be 100%. Even though it's the best in the world, our system for corporate oversight is far from perfect. The collective power of directors, auditors and regulators to protect shareholders withers in the face of serious corporate corruption. It's amazing what con men can get away with for a while.

- As Enron's complex, questionable transactions indicate, the people looking for holes in the rules are often highly motivated, well financed and well advised. Those whose job it is to plug the loopholes are often over-matched, and their efforts to do so usually amount to a holding action. The furor over Enron's accounting shows that we need the ability to insist on adherence to general principles and punish those who violate them.
- Security analysis and knowledgeable investing aren't easy. Investors must be alert for fuzzy or incomplete information, and for companies that don't put their interests first. They must invest only when they know what they don't know, and they must insist on sufficient margin for error owing to any shortcomings.
- We all must watch out for unintended consequences, and that's especially true when promulgating regulations. Accounting rules and option programs were created with the best of intentions, but in the extreme they led to Enron's noxious transactions and counterproductive incentives. It'll be no less true the next time around.

I apologize for the length of this memo, but the Enron matter is so sweeping and multi-faceted that I found it inescapable. It is my aim here to shed light, not to recount events. I hope you'll find it interesting and of use.

March 14, 2002

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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

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Memo to: Oaktree Clients

From: Howard Marks

Re: Quo Vadis?

Leon Uris turned the question "Quo Vadis?" into a book title. Everyone wants to know. **Where do we go from here?** What's in store for the market?

. . . for all the drama, yesterday's seesaw trading failed again to give investors the one thing they needed most: a clear picture of where the stock market is headed. Many on Wall Street had been hoping for some kind of resolution yesterday – either a significant drop that would wash out the selling, or a significant recovery. Instead, stocks bounced in both directions, as optimists battled the pessimists. (Wall Street Journal, July 24, 2002)

I include this paragraph because it communicates a great deal in just a few words. It makes clear how much investors hunger for an indication of what lies ahead. It shows how inconclusive anyone day's evidence can be. And, most importantly, to me it hints at the sheer folly of this quest for an omen. **There's no such thing as a conclusive sign, and there never will be. The future will always remain a mystery – and this is even more true for short-term fluctuations than for long-term trends. Nothing in the market's movement one day tells us anything about what it'll do the next. Most of the time people will conclude that they have no idea what lies ahead. And once in a while they'll feel they do (as in 1999) and likely be wrong.**

I know my views on the market's direction aren't worth betting on. But while I can't tell you what lies ahead, perhaps I can be of service in my usual way, by marshalling the arguments on both sides and giving you my take on them.

Starting Point

This attempt to provide insight into the market's future course should be understood in light of a few caveats. The most important are these:

First, we are living through the most extreme boom-bust episode of my 33-year investment career and, I think, the most extreme since the Roaring Twenties and subsequent market crash. The magnitude and craziness of the bull market and tech-media-telecom bubble of the 1990s dwarfed every up-leg I've seen, and the correction that started 28 months ago already ranks with the greatest down-legs. Thus all bets for "normalcy" are off. A huge decline like we've had doesn't necessarily create bargains if preceded by a huge advance.

Second, no one knows what the future holds, especially in the short term. **The movements of markets are primarily determined not by physical laws, but by the reaction of emotional humans to developments in their environment. These reactions are well beyond accurate prediction.** The fraternity of would-be forecasters consists of people who've been right once or twice, giving them credibility, and people who've never been right. None of them has a high probability of being right this time.

Third, the market's "observable historic patterns" (a) are very inconsistent and (b) have been derived from a small number of observations over a period of just a century or so under widely varying circumstances. Thus these historic patterns are of very limited relevance in predicting this market's next move.

Last, I want to admit that, as usual, my analysis is likely to overweight the negatives and the rebuttals to the positives. I've been cautious for a long time – in fact, I don't remember ever having written a bullish piece on stocks – and this memo is unlikely to be any different. There are "horses for courses," and I admit it: I'm usually going to cost you money on the upside.

Taken together these caveats mean that very little trust, if any, should be put in any market prediction – especially mine.

Positive Arguments

One of the strongest arguments for buying now cites the market's departure from one of those historic patterns referred to above. The New York Times stated it clearly on July 21:

Using history as a guide, the stock market should be higher now than it was a year ago. Since 1948, six months after a recession's trough, stocks have jumped an average of 24 percent from the previous year. But at the end of June, six months from the recession's probable end, stocks were down 18% from last year. **That means the market has underperformed its typical post-recessionary move by 40 percentage points.** [Emphasis added]

Supporting this is the widespread and not unreasonable belief that the economy is no longer in decline and a modest recovery is underway. While it is difficult to identify many pockets of great strength in the economy, there is no evidence that the aggregates are still trending down.

Buttressing the economic outlook are recent movements in currency exchange rates. The dollar has stopped appreciating relative to other currencies and in fact has moved 10% lower. This means, for example, that it now takes fewer euros to buy a dollar and more dollars to buy a euro. Thus, everything being equal, U.S. goods are now cheaper than foreign goods. This should serve to increase U.S. manufacturers' sales to Americans and foreigners alike.

The improving environment seems to have taken the downward pressure off profits and slowed the flow of earnings disappointments. As reported by the Wall Street Journal on July 22, "Nobody wants to hear it, but companies are beating their numbers again . . . Of the 208 companies from the S&P 500 that have reported [midyear results] so far, 58%, or 120 companies, earned more per share than analysts had estimated . . . Only 14%, or 29 companies, have missed estimates." (Bear in mind, however, that "earnings ahead of estimates" is not necessarily the same thing as "earnings ahead of last year." This data could simply mean that the comparisons are against estimates that had become too pessimistic.)

I see technical indicators that are encouraging. There are a number of signs that optimism is being wrung out of the market and fear is replacing greed. For example, when the Dow fell 390 points on Friday, July 19, the NYSE saw:

- new lows outnumber new highs by almost fourteen to one (386 vs. 28),
- more than three times as many stocks decline as advance (2,467 vs. 766),
- all of the 30 Dow Industrial stocks decline, and
- an all-time record number of shares change hands (2.63 billion shares, only to be exceeded in the rally of July 24).

In addition, there have been several days this year when 80% or 90% of the trading volume took place on downticks, and cash outflows from equity mutual funds have been substantial.

Certainly investor behavior has turned bearish. Selling sometimes seems indiscriminate. Every better performing group gets its turn in the barrel. The value stocks that outperformed for the last two years are sharing the pain of the growth stocks. It seems there's no place to hide. Investors complain that they can't take it and have started to throw in the towel. **Maximum panic usually coincides with minimum prices.** Thus these may be signs that capitulation, the exhaustion of selling, and a bottom are near.

Negative Arguments

On the other hand – as any good politician would say – there are counter-arguments to many of the above, and a large number of additional negatives to be considered.

In my opinion, just as the strongest positive is seen in the failure of the market to reflect the ending of the recession, I think the counter to that – and the strongest negative – lies in the matter of valuation. **In short, the fact that stocks are down since the end of the recession, and down a great deal from their peak, doesn't mean they're cheap.** In fact, most rumination on the market's future direction touches on the correction, investor psychology and the economy, but not whether stocks are rich or cheap, always a difficult subject to plumb.

The impact of a decline must be gauged in light of its starting point. Stocks ended up cheap after the S&P's 1973-74 decline of 48%, but that's because the average P/E ratio started in the high teens and ended in single digits. Thus this correction's 45% decline doesn't necessarily have equal import, given that it started **and ended** with an average P/E ratio above 20!

Of course, a case continues to be made that stock valuations are attractive (or, more typically, "are not unattractive") because of the low level of interest rates. Low rates raise the discounted present value of a given stream of future cash flows, and they reduce the competition that stocks face from bonds. **As I see it, much of the case for the fairness of valuations today rests on the view that low prospective returns on stocks are reasonable given the low prospective returns on fixed income instruments. Maybe this makes stocks cheap at today's P/E ratios, but I don't consider it much of a positive.** Further, in order for interest rates to continue to render stocks attractive, they must stay low. But low rates presuppose low levels of economic growth, demand for capital, and inflation. Are these the arguments on which to build a bullish case?

There's also a strong counter-argument regarding economic recovery. As stated by Jan Hatzius, the senior economist at Goldman Sachs, it goes as follows:

Unfortunately, the effect [on the economy] of the stock market's sorry performance has yet to be felt. . . Normally, when you get a big stock market setback, consumers have a harder time getting credit. But there are more alternative sources of credit for consumers now and the Fed is very eager to keep access to credit good. . . Once consumers realize that the stock market will no longer bolster their savings, they will rein in spending and start setting aside more income. That will be a big negative for consumer spending, the only area of the economy that has been strong. (NY Times, July 21, 2002)

Certainly with about \$7 trillion of equity value having been erased since the market's peak in March 2000, investors are sure to be feeling a lot poorer, and thus there is reason to question the longevity of strong consumer spending. Bulls often touted the "wealth effect" in 1998-99, but we hear much less about it these days. Yet concern that consumers will cut spending is one of the reasons there is fear of a double-dip recession.

And the negative ramifications aren't likely to be limited to consumers. Corporations will feel their share of pain from the market's decline. First, they may have to come up with cash for contributions to pension funds, and there may come a time when they will no longer be able to augment income with "actuarially assumed" investment returns that aren't occurring. Second, lower asset values may shed doubt on the billions of dollars of acquisition goodwill now present on balance sheets. Third, the prevalence of out-of-the-money options – and the negative recent experience with them – may make employees clamor for cash compensation, with negative implications for net income and cash flow. In this environment, corporations may have a lower propensity toward capital spending.

Governments at all levels also are likely to see their revenues decline. The Federal government will run deficits, (the end of which was one of the factors lifting the market in the late 1990s), and the states and cities will cut back on spending, with a retarding effect on the economy.

If both individuals and institutions have less cash to invest and less willingness to part with it, our reliance on foreign capital is likely to become clearer. But with foreign investors no longer feeling they can count on the dollar to be worth ever-increasing amounts of yen or euros, inflows of those currencies for dollar investments are less dependable. The implications for security prices and capital formation are obviously negative. And questions about our system's integrity and transparency can't help.

Beyond the fundamentals of economy and valuation, there are a vast number of psychological factors to be considered:

- Of course, cynicism prompted by corporate misdeeds tops the list. Who'll invest in the face of the corruption at "all these companies"? How many investors realize that the dishonest acts have been limited to a handful of firms? Or that there is a difference between aggressive accounting and fraud? Who'll believe even the simplest of management's statements about cash in the bank or the next quarter's earnings? (By the way, I think the recent exposure itself can be counted on to produce better corporate behavior. Already companies are scrambling to show they're clean in terms of accounting, governance, and executive compensation.)
- Certainly the belief in the inevitability of stock market profits has been dispelled. Who still believes that "stocks can be counted on to beat bonds and cash"? (Okay, nothing has changed regarding the long run, but investors have learned that living through a negative short run isn't that much fun.) And who still believes that the "efficient market" can be relied on to price stocks right? For these reasons, I think millions who were suckered into investing without the necessary expertise or awareness of risk will drop out for a while.
- Likewise, the 1999 mantra of buying on dips has been laid to rest. Those who tried it in the last 28 months have paid a high price for investing on autopilot, and they are unlikely to rise up and counter the bears' selling any time soon. Sure, stocks will rise again, but few of the burned investors are worried about missing the first ten percent.
- The leaders that people counted on to make them rich in 1998-99 are gone from the scene, and no one's likely to win investors' confidence anytime soon. Alan Greenspan's words no longer have the same soothing effect; now he's blamed for fostering too much liquidity, too great a market bubble, and then too-high interest rates. Likewise, investors have learned painfully that bullish statements from analysts and strategists precede up markets and down markets alike. Without "trusted advisers" they can count on, investors won't be as quick to jump aboard the next bandwagon.

- Macro fears still loom in the background, and they gain more credence when people feel less good about things. The threat of further terrorism, unending violence in the Middle East, nuclear and biological weapons in the hands of rogue states, and even Japanese-style deflation – none of these fears can be put to rest conclusively.

Of course, like almost everything else, these psychological factors have two sides. They're negatives to the extent they contribute to fear and skepticism and thus discourage buyers. But they're positives if they induce panic selling and take prices low enough to form a bottom.

Lastly, I think we all should worry about Washington. Where's the political payoff today? It lies in decrying corruption and calling for extreme reforms. The backlash against corporate malfeasance I cited in "Learning From Enron" certainly threatens to become a witch-hunt, raising great risk of tampering with a system that's essentially sound. Regardless of whether properly motivated or not, the government should not be in the business of codifying rules in areas such as accounting and compensation.

Foreseeing second-order consequences is difficult, and particularly so for politicians and regulators. Not only are they often unknowable, but also they exist in the long term, whereas people in politics are governed by short-term considerations – like getting re-elected. Capping the price of natural gas was popular, but we saw too late that it keeps people from drilling. Controlling rents seemed desirable, but no one foresaw that it would discourage landlords from building housing and renters from moving out. There's little I'm sure of, but I do believe that if the government establishes rules and procedures in areas that should be the province of the market, (a) there will be unintended consequences, and (b) the rules will be much harder to correct than they were to enact.

* * *

I believe strongly that things will not get worse forever. We'll muddle through. Given the retarding effects of lobbyists and competing political interests, the government probably won't do anything terribly destructive. The economy will come back. Most companies will be shown to make real profits, and their securities will turn out to have value. **In other words, the financial world won't come to an end.**

As for short-term direction, no one knows which way the market's going to go, or whether the declines to date are enough to offset the negatives and make this a bottom. Do the declines to date and the economic recovery that's underway mean we're at the bottom? Or do the abject disillusionment that investors have suffered and the still-high P/E ratios mean it won't be reached for a while? The answer rests on the actions of investors in the coming weeks and months, and that truly defies prediction.

When I think about whether the brouhaha over corporate misdeeds will soon die down, I worry about the following:

- When the replacement auditors show up at each former Arthur Andersen client, they'll be bringing their fine-tooth combs. They'll have every incentive to find something wrong in the previous accounting and absolutely no incentive to say, "Everything was just fine."
- With or without suggestions from new auditors, every management team will be motivated to amend its accounting. First, they'll want to join the holier-than-thou parade. Second, they know choosing a more aggressive accounting treatment will leave them open to criticism or worse. Last, they are likely to engage in the usual deck clearing to put costs and restatements behind them, prodded, in particular, by the requirement that they certify financial statements starting in mid-August. The sum of this may result in months of additional disclosures and restatements.
- More virtuous accounting practices, including specifics like the expensing of option grants, are sure to mean lower reported profits than otherwise would have been reported. You might say investors will look beyond these numbers and perceive the lower quantity of earnings to be offset by the higher quality. I doubt it. I think the first-year shift to this new regime could make companies seem generally less profitable.
- Politicians will keep battling to show who's less tolerant of corruption. Democrats will pick on Republicans for their closeness to business, and Republicans will strive to show they're just as tough as Democrats. I think this is overwhelmingly likely to last through the November elections.
- The media will throw gasoline on the fire as always, rising up in indignation whenever they detect a sensational story. The stories are too good, the targets are too rich and attractive, and the rewards for resisting sensationalism are few and far between. Reporters who were pro-investment and pro-free market just a few years ago now see the greatest gains in calling for scalps. And I can just hear the talking heads on CNN and MSNBC saying, "I never liked the stock market anyway."

When I put it all together, I come down, as usual, on the cautious side. I'm not confident that the excesses of the bull market of 1982-1999 and the enormous tech bubble could have been corrected in just 28 months. Stocks' current swoon need not go on without end, but I see fundamental, valuation and psychological problems that will take time to fix. Maybe there'll be some lackluster years rather than a continuous collapse. It's said the investors who were burned in the excesses of the 1920s didn't return to the market until 1955 – or was it their kids?

I doubt there'll be a massive revival of the popularity of stocks any time soon, and thus I wouldn't count on a quick return to performance in line with history. **More than ever, I think non-market-derived, skill-based value added – that is, alpha, not beta – will**

hold the key to investment performance. Because owners of capital may not be able to count on a tailwind like we enjoyed in the 1980s and 1990s, managers with great skill remain the strongest hope. And in this climate, I'd rather bet on risk control than risk bearing as the route to superior results.

July 26, 2002

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Memo to: Oaktree Clients
From: Howard Marks
Re: Etorre's Wisdom

My memos evoke a wide variety of reactions. One I hear most often is "where do these ideas come from?" This memo will serve as a good example: it was inspired by a ride I took this summer with my son Andrew. That, in turn, reminded me of a clipping that's been sitting in my files since the early 1970s.

The newspaper article, entitled "The laws that rule frustrating lives," enumerates a dozen principles that we suspect are at work on our bad days. Here are a few examples:

- Everyone knows the first, Murphy's Law: If anything can go wrong, it will.
- Fewer people, however, are conversant with O'Toole's Commentary: Murphy was an optimist.
- There's a lot of truth in The Unspeakable Law: As soon as you mention something, if it's good, it goes away; if it's bad, it happens.
- Every parent of a toddler has seen The Law of Selective Gravity in action: An object will fall so as to do the most damage.
- But the one that's least controvertible is Etorre's Observation: **The other line moves faster.**

While I was driving with Andrew he asked, as fifteen-year-olds are prone to, "Dad, why do you always have to drive in the slow lane? Why don't you switch to that one; it's moving faster?" As I wound up for a lengthy explanation, **I recognized in his comment the greatest imaginable metaphor for investor behavior.**

What is it like to drive on our crowded highways?

- We often sit there, frustrated, watching cars whiz by in the adjacent lane.
- However, if we change to the faster lane, it slows down just as the one we left speeds up.
- Sometimes a lane-jumper shoots past us, but we know deep down that drivers who constantly shift from one lane to another are unlikely to reach a given point much before we do.

I think there are many ways in which the experience of drivers on a crowded highway is similar to that of investors. I'll touch on them below, and on what I see as the reasons (and the lessons).

Finding Your Way on an Efficient Highway – Some people find it difficult to understand the concept of efficient markets, and how efficiency makes it hard for investors to outperform. It's really for this that a crowded highway is the perfect metaphor.

Most drivers share the same goal: we want to get there as quickly as possible, with safety. A few people drive like slowpokes, sacrificing speed for excessive safety, and a few others are maniacs who keep the pedal down without a care. The vast majority of us, however, conduct ourselves reasonably but really would like to cut our travel time.

As we drive along, we see from time to time that another lane is moving faster than ours. Just as obviously, however, we know that jumping to that lane is unlikely to bring much net improvement.

And that's where the metaphor comes in. If I could switch to the faster lane while everything remained unchanged, doing so would cut my travel time. **But everyone sees which lane is moving fastest, and if everyone switches into that lane, that will make it the slow lane.** Thus the collective actions of drivers alter the environment. In fact, they create the environment.

In April 2001, I wrote the following in "Safety First . . ."

Over the years, performance has constantly improved in areas like golf. That's because while the participants develop new tools and techniques, the ball never adjusts and the course doesn't fight back. But investing is dynamic, and the playing field is changing all the time. The actions of other investors will affect the return on your strategy. Just as nature abhors a vacuum, markets act to eliminate an excessive return.

What I meant is that, unless the Greens Committee changes the layout, a golf course is a static environment. The actions of golfers don't change the game. If I try a certain approach to a hole – or even if everyone does – that won't alter the effectiveness of the approach.

In contrast, highways – like markets – are dynamic environments. What the other participants do on a given day goes a long way toward determining what will and will not work for us. When people flock to the fast lane, they slow it down. And with the lane they left suddenly less crowded, it speeds up. **This is how the "efficient market" in travel acts to equalize the speed of the various lanes, and thus to render ineffective most attempts at lane-picking. Efficient securities markets work the same way to eliminate excess returns.**

Everyone knows what has worked well to date. Just as they know which lane has been moving fastest, they know which securities have been performing best. Most people also understand there is no guarantee that past performance will continue. **What is a little less widely understood, however, is that past returns influence investor behavior, which in turn alters future performance.**

While investors have the option of switching into the securities that have been performing best, most know the outperformance isn't likely to last forever. It takes a little more

insight, however, for them to comprehend that their switching will be, in itself, among the things that change performance. When people switch to the better-performing group, their buying bids up the prices of those securities. That bidding-up prolongs the outperformance somewhat, but it also reduces the prospective return and increases the probability of a correction. (The higher the price you pay, the worse your prospects for profit. This seems like a simple concept, but it's forgotten once in a while – as it was in the tech bubble.)

At the same time, the switchers will sell worse-performing securities to finance their move into the hot group. That will lower the prices of the laggards, and at some point they'll be so cheap that they become destined to outperform.

For How Long Will the Fast Lane Go Fast? – The pedal-to-the-metal momentum crowd saw the tech and telecom stocks moving fastest in 1999 and extrapolated their outperformance to infinity. In essence, they assumed one lane could go faster forever. Of course, they ignored the fact that the stocks were being bid up to prices from which collapse would be inevitable. They also failed to notice that the "slow lane" value stocks they were selling would eventually become primed for acceleration.

How long can outperformance continue? How long can one lane be the fastest, one strategy be the best? Clearly, there's no rule. The momentum players behind the bubble proved with certainty that fast rising stocks will keep rising until they stop. They also proved, to their surprise, that few people are capable of getting off just as the upward trajectory peaks out.

As I've said many times, anything can work for a while, but nothing can work forever. Sometimes large cap works, and sometimes small cap works. Sometimes domestic works, and sometimes international works. Sometimes buying leaders works, and sometimes buying laggards works. Wall Street has pushed out some incredible gibberish over the years, but nothing quite like that embodied in another yellowed clipping from 1976 (maybe this is why there's no more Loeb, Rhoades):

A continuing pattern of consolidation and group rotation suggests that increasing emphasis should be placed on buying stocks on relative weakness and selling them on relative strength. This would be a marked contrast to some earlier periods where emphasizing relative strength proved to be effective.

I guess that's a fancy way to say that sometimes the stocks that have been doing best continue to do best, and sometimes the stocks that have been doing worst start to do best. (Really, I don't make this stuff up.)

The Tactics Others Adopt – The fact that crowded highways are efficient allocators of space doesn't mean people don't try to beat them. How often do we see the guy in the souped-up '67 Mustang careen back and forth just in front of us, changing lanes every minute and cutting off half the cars on the road? But does he get there any faster? Should he expect to?

Of course, the analogy to investing holds beautifully. Knowing which lane to drive in has nothing to do with which lane **has been going fastest**. To chart the best course, one must know which one **will go fastest**. As usual, outperforming comes down to seeing the future better than others, which few drivers on crowded highways can do.

So half the time the lane-jumper moves into a fast-moving lane that keeps going fast, and half the time into one that's just about to slow down. And the slow lane he leaves is as likely to speed up as it is to stay slow. Thus the "expected value" of his lane changing is close to zero. And he uses extra gas in his veering and accelerating, and he bears a higher risk of getting into an accident. Thus the returns from lane changing appear modest and undependable – even more so in a risk-adjusted sense.

There are lots of investors in our heavily populated markets who believe (erroneously, in my opinion) they can see the future, and thus that they can get ahead through market timing and short-term trading. Most markets prove to be efficient, however, and most of the time these machinations don't work.

Still, investors keep guessing at which lane on the investment highway will go fastest. They are encouraged by the successes they recall and the gains they dream of. But their recollection tends to overstate their ability by exaggerating correct moves and ignoring mistakes. Or as Don Meredith once said on Monday Night Football, "they don't make them the way they used to, but then again they never did."

So most investors go on trying to time markets and pick stocks. When it works, they credit the efficacy of their strategy and their skill in executing it. When it doesn't, they blame exogenous variables and the foolishness of other market participants. And they keep on trying.

In the ultimate form of capital punishment, the hyper-tactician – on the road or in the market-stands a good chance of repeatedly jumping out of the thing that hasn't worked just as it's about to start working, and into the thing that has been working moments before it stops.

This is why it's often the case that the performance of investors in a volatile fund is worse than the performance of the fund itself. On its face this seems illogical . . . until you think of the unlucky lane-jumper described just above. People often jump into a hot fund toward the end of a period of good performance, when overvaluation in the market niche (or hubris on the manager's part) has set the stage for a fall, and when the great results have brought in so much money that it's impossible to keep finding enough attractive investments. By the time a hot fund falls, it's usually much larger than it was when it rose, and thus a lot more money is lost on a 10% drop than used to be made on a 10% rise. It's in this way that the collective performance of a fund's investors can be worse than that of the fund.

There are prominent examples of money managers who started small, made 25% a year for 25 years, got famous and grew huge, and then took a 50% loss on \$20 billion. I often

wonder whether their investors enjoyed any cumulative profit over the funds' entire lives. Just as lane-jumping is risky on the road, following the hot trend is risky in the investment world.

Isn't There a Way to Make Good Time? – If crowded highways are truly efficient, and the fast lane is destined to slow down, is there no way to do better than others?

My answer is predictable: find the inefficiencies. Go where others won't. Do the things others avoid. We all have our tricks on the road. We'll take the route with the hazards that scare away others – after we've made sure we know the way around them. Or we'll take the little-known back road. We'll go through the industrial area, leaving the beautified route to the masses. Or we'll drive at night, while others prefer the daylight.

All of these things are analogous to the search for inefficiency in investment markets. At Oaktree we invest in things that others find frightening or unseemly – like junk bonds, bankruptcies and non-performing mortgages. We spend our time in market niches that others ignore – like busted and international convertibles, and distressed debt bought for the purpose of obtaining control over companies. We try to identify opportunities before others do – like European high yield bonds and power infrastructure. And we do things that others find perilous, but we approach them in ways that cut the risk – like investing in emerging markets without making sink-or-swim bets on the direction of individual countries' economies and stock markets.

I continue to believe there are ways to earn superior returns without commensurate risk, but they're usually found outside the mainstream. **A shortcut that everyone knows about is an absolute oxymoron**, as is one that's found where the roads are well marked and mapped. The route that's little known, unattractive or out of favor may not be the one that's most popular or least controversial. But it's the one that's most likely to help you come out ahead.

September 4, 2002

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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'etre* 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 "Pooled 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

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Memo to: Oaktree Clients
From: Howard Marks
Re: Whad'Ya Know?

I always ask Nancy to read my memos before I send them out. She seems to think being my wife gives her license to be brutally frank. "They're all the same," she says, "like your ties. They all talk about the importance of a high batting average, the need to avoid losers, and how much there is that no one can know."

Well, I guess I do tend to go on about everything that investors would like to know but is unknowable . . . and about all the people who claim to know it. But I've saved up some good stuff for a "rant" regarding the "I know" school people who think they know but don't. So here I go again (with apologies for the length).

The "Jumbo Shrimp" of Investing

One of my favorite oxymorons is "common knowledge." Knowledge just isn't that common, and that which is common often contains little knowledge.

On February 4, USA Today cited a strategist as saying "there might be a silver lining to the current investor backlash, because a lot of cash is piling up on the sidelines, and the heavy selling has wrung out most of the downside." **Everyone knows** the stock market can't stop sliding and begin a new bull phase rally until some cash has piled up on the sidelines. And thus everyone wants to see selling exceed buying. That seems eminently reasonable.

And that's what makes it one of my greatest pet peeves. It makes sense, it's obvious, and people have been saying it for decades, so it has become common knowledge. But it's wrong! **There's no such thing as net selling! And stock market transactions can't cause cash to build up!** Think about it. In every stock trade there's a buyer and a seller. So how can selling exceed buying? And the buyer puts as much money into the market as the seller takes out. So how can selling create cash on the sidelines?

As usual, there is a less simplistic explanation that's closer to the truth:

- While there can't be more selling than buying, there can be more would-be sellers than would-be buyers. And the sellers' desire to sell can be stronger than the buyers' desire to buy. These factors are indicators of negative sentiment, and they can lead to a selling climax that creates a market bottom, so they can presage the (eventual) end of a decline.
- And clearly, uninvested cash equates to potential buying power, and thus potential fuel for a rise. But uninvested cash can't result from selling (which requires a buyer to put in the same amount of previously-uninvested cash as the seller takes out). Rather, a buildup of potentially

investable cash must come from sources that are exogenous to the market, such as household income, savings, tax refunds, and cash contributions to pension funds or endowments.

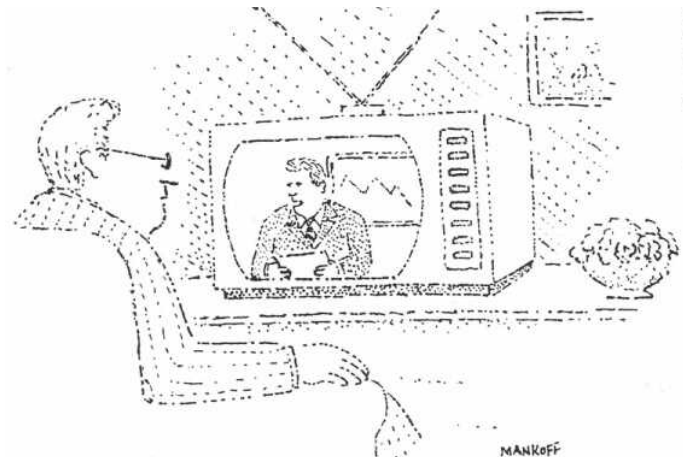
The bottom line: there's often no wisdom in the stuff that "everyone knows." And nowhere is that more true than in investing.

Toward Understanding Market Movements

One day in early 1995, the dollar made a big move against the yen. On my way to work, my radio station's Tokyo correspondent reported that the Nikkei average of Japanese stocks had been off big that day. He was glad to explain why: investors were worried about the weakness of the yen.

On my way home, the same station reported that the U.S. stock market also had declined a lot. The explanation given: investors were concerned about the strength of the dollar.

Well that just can't be. If one currency moves relative to another, how can companies in both countries be worse off than they were the day before? I think this episode illustrates a few themes. First, the general understanding of economic events and their implications is very poor. Second, everyone wants to explain the movements of the markets, and they'll grasp at any straw with which to do so. Third, much of their commentary is useless. And, of course fourth, **markets often do things that defy logical explanation – but people keep explaining them anyway.**



"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."

New Yorker Magazine, 1981

Every day we hear or read that "the market rose on hopes that . . ." or ". . . because investors were cheered by the news that . . ." Or perhaps it's "the market fell on fears that . . ." or ". . . because of negative reaction to . . ." How do the commentators know? Where do they look to learn the reason for each day's move? Does there have to be an explanation? **Why don't we ever hear, "The market rose today, but no one knows why"?!**

So What's The Point?

I don't begrudge people wanting to make money by expressing views that are beyond their ken and of no value. I guess it's human nature. My complaint, however, is that it's misleading and injurious to bystanders when people use serious platforms to state their unfounded views. They make it seem so easy to understand economic and market developments, and thus to profit from them. Just as no one should give legal advice or medical diagnoses on TV, the media should desist from providing economic and market analysis as well.

I think some of the greatest contributors to the 1998-99 bubble were the talking heads of the media. For every event they provided a without-a-doubt explanation and quantified its profit implications. These "experts" were free with recommendations and exuded 100% certainty. As I've said before, there are a few things they **never** said: "darned if I know," "it's hard to predict these things," and "but I could be wrong."

Nobody was well served by the veneration of the "I know" school in the late 1990s: Main Streeters were lured to invest in Wall Street without an understanding of the skills required or the risks entailed. The market and thus the economy were put through an extreme boom-bust cycle. Risk-taking investment gunslingers were anointed, and cautious value seekers were rendered irrelevant. And the oracles themselves eventually were brought low – they seem much less free with gratuitous wisdom and can't-miss buy recommendations today than they were four years ago.



New York Times, March 15, 2001

Where Were the Strategists?

Another group that's no longer riding quite as tall in the saddle are the brokerage house strategists. They attracted a lot of respect in the '90s, and some even attained "household name" status. But I don't know of any who helped their clients avoid the pain of the last three years.

I think the test is simple: Did they call the TMT bubble? It's obvious in retrospect that many of the tech/media/telecom companies and their strategies were somewhere between fanciful and fictitious; the valuation multiples were ridiculous; investor behavior was nuts; and Wall Street had turned into a machine for short-term appreciation. **If it's so obvious in retrospect, lots of the strategists (whose sole job it is to figure out what's going on and what it means for the future) should have had an inkling at the time.**

Since this was the most extreme event of our investment lifetime thus far, and since it built up in plain sight over a period of years (as opposed to being the result of a sudden and surprising exogenous influence), shouldn't the strategists have seen it? **The emperor was as naked as he's ever been, but the brokerage strategists failed to point it out.**

Abby Joseph Cohen was the most prominent of the strategists, having made a real name for herself by correctly predicting stock price gains for a decade or more. (Or was she simply an unmitigated bull who never changed her tune regardless of the level of stock prices and looked smart in the '90s?) I attended a meeting with her near the top and heard the tortured rationalization that allowed her to stay bullish, something like: "Stocks are overpriced, but not by a lot, so based on our outlook for interest rates and other factors, they're still a buy." My opinion's a little different: When an asset's overpriced, it can't be a buy.

When I think about the events of the past decade, I conclude that the strategists failed to warn about the risk in stocks because of some combination of (a) their congenital bullishness, (b) Wall Street's vested interest in predicting stock price appreciation, and (c) the serious limitations on knowing what the future holds. Rarely have so many been paid so much for contributing so little.

On that note, The New York Times wrote on January 27:

When Barton Biggs announced last week that he would be leaving his job as Morgan Stanley's chief global strategist, it may have marked the end of a bull market phenomenon – the transformation of market strategists into celebrity gurus. . .

Several Wall Street firms are reassessing the role of the highly paid stock strategist. Under intense pressure to cut staff costs in the bear market, investment banks not only have been downgrading the role of the strategist, but also have been questioning whether the position as it exists is relevant in today's complex market environment. . .

These concerns rarely appeared during the boom years, when Mr. Applegate [late of Lehman Brothers] and Mr. Galvin [ex. Credit Suisse First Boston] became minic celebrities by cultivating hip personas in print and on CNBC. . .

Lehman Brothers and Credit Suisse, which declined to comment on the strategists' departures, have decided that, for now at least, they can make do without well-known prognosticators.

Perhaps the website FierceFinance summed it up best that same day: **“Now, Wall Street firms are pondering whether [star strategists] have become anachronisms. It reminds me of the perennial debate in Great Britain about the need for royalty in the modern era.”**

How Do They Rate?

While we’re on the subject of who knows what, we should consider the credit rating agencies. These organizations are dedicated to assessing the quality of debt securities. They’ve been around for scores of years and are viewed as objective. So highly are they thought of that their ratings are accepted as regulatory standards and incorporated into law; there’s even a special SEC label for them: “nationally recognized statistical rating organizations.” But do they do any good?

I confess: I love the rating agencies! Oaktree would be lost without them. My whole career and many of Oaktree’s activities are based on opportunities created by credit ratings.

First, a digression: In an efficient market, there’s no chance for superior returns through active management. Active managers need markets that are inefficient. **What are inefficient markets? They’re markets where mistakes are made;** where assets sell for prices different from their fair value and thus can be bought for less (or sold for more) than they’re worth. In order for those mistakes to occur, there has to be ignorance, inadvertence, opacity, prejudice, emotion, or some other obstacle to objective, insightful decision making.

The ratings agencies constitute just such an obstacle. My favorite example: literally for decades, Moody’s has defined B-rated bonds by saying they “generally lack characteristics of the desirable investment.” How can they say that based on the risk alone, without any reference to price or promised return? Once they imply “there’s no price at which this bond could be a good buy,” people will shun it, making it cheap. That can create an opportunity for a bargain hunter.

And the ratings agencies are wrong a lot. Not in every case, but at the margin where it counts. **The agencies are convinced they do a good job because the bonds they rate low default more often than the bonds they rate high. But the majority of speculative grade bonds never default, and every once in a while an investment grade bond does. Both of these phenomena have significant financial consequences.**

For example, by failing to anticipate a default and thus mistakenly maintaining an investment grade rating, the agencies allow bonds to sell at 80 that should sell at 20. That’s an opportunity: for investment grade bond managers to distinguish themselves by getting out before the default, and for hedge funds to profit from selling short. And when the sense of security caused by those high ratings is dashed, investment grade bond managers can be forced to dump these now-nonconforming bonds, creating bargain-priced opportunities for buyers of distressed debt.

If the rating agencies were right every time, the bond market would be efficient; every bond’s yield would be just right for its risk, and there would be no free lunch, no excess return. And if there were no rating agencies, there’d be no organized process for us to game against. In either case the opportunities for Oaktree to buy cheap on behalf of its clients would be reduced. But I don’t think there’s any risk of that. **The concept of accurate ratings is dead; long live the rating agencies!**

Often Wrong But Never In Doubt (or Hesitant to Share)

The January 6 issue of “Pensions & Investments” contained its 2003 Investment Outlook. Twenty institutional money managers generously provided their views on what the coming year holds. They ranged from cautiously bullish to outright bullish. The headlines on the more restrained forecasts included:

“‘Double-Dip’ a Possibility,”
“Recovery with Headwinds,”
“International Surprises Likely,”
“Moving Sideways Toward a Bull Market,”
“It Will Be a Stock-Selective Market,” and
“Blame Iraq”

The outright optimists said:

“The Worst is Behind Us,”
“Rocking and Rolling Before Long,”
“Healing Process Is Already Well Along,”
“Bullish on Credit,”
“Crisis of Confidence Is Over,”
“Bullish on Equities,”
“We Are . . . in a Recovery,” and
“Extraordinarily Bullish for 2003.”

The most guarded forecaster said the market could be close to flat; nobody said “down.”

One of my greatest complaints about forecasters is that they seem to ignore their own records. I’ve never heard one say, “I predict such-and-such will happen (and 7 out of my last 10 forecasts were off the mark)” or “I predict such-and-such will happen (and, by the way, I predicted the same thing last year and was wrong).” However, P&I did the unusual by critically reviewing the previous year’s forecasts. It poked a little fun at the West Coast manager who predicted the S&P 500 would gain 15% in 2002, whereas it declined 22% instead. (He’s again predicting a 15% increase for 2003; if he keeps at it long enough, he’s bound to be right someday.) But P&I went one better by pointing out that at the start of 2002, one of the worst years in stock market history, “not a single one of 19 stock managers interviewed . . . predicted a negative return for the U.S. stock market.”

The amazing thing to me is that these people will go on making predictions with a straight face, and the media will continue to carry them.

The Value of Predictions II

The P&I survey reminded me of a memo I wrote in 1996 under the above title. It reviewed a few of The Wall Street Journal’s semiannual economic surveys and made several key points, not one of which I would alter:

The average “expert” added little in terms of predicting the future.

It’s not that the forecasters were always wrong; when there was little change, they were often right. It’s just that in times of major changes (when accurate forecasts would have helped one make money or avoid a loss), the forecasters completely missed them. In the years reviewed, the expert consensus failed to predict **all** of the major developments.

Where do these forecasts come from? The answer is simple: If you want to see a high correlation, take a look at the relationship between current levels and predicted future levels. . . In general we can say with certainty that these forecasters were much better at telling us where things stood than where they were going.

Every six months, when the Journal reports on a new survey of forecasts, it takes the opportunity to cite the forecaster in the previous survey who came closest . . . And the truth is that the winner’s accuracy is often startling. . . . [However,] the important thing isn’t getting it right once. It’s doing so consistently. . . As the Journal itself pointed out, “. . . by giving up the comfort of the consensus, those on the fringes of the economic prediction game often end up on the winning or losing end. . . the winners of six months and one year ago didn’t even get the direction of interest rates right this time.”

None of this provides much encouragement for those who would invest based on guesses about the future. **But neither, apparently, does it provide enough discouragement to make them stop.**

Predicting the Events That Move Markets

I often write about how difficult it is to anticipate the things that will determine the direction of the market. Think about it: what events in the last five years do you wish you’d seen coming?

- The meltdown of Long-Term Capital Management in 1998.
- The tech/media/telecom boom in the late 1990s.
- The tech/media/telecom collapse in 2000.
- The terrorist attacks in 2001.
- The corporate scandals in 2001-02.
- The interest rate decline in 2002.

Did you foresee many of these things? Did your money managers? Did anyone? I doubt it.

The market’s big moves often come in reaction to surprises like these. But most of the time, the consensus anticipates continuation of the status quo (especially when things are going well). Surprises aren’t factored into prices ahead of time (by definition). In the movie that runs inside my head, the members of the “I know” school sagely intone, “We’re not expecting any surprises” (without appreciating the irony). **It’s when surprises occur that big profits are there for the taking – by anyone capable of foreseeing them. It’s just that it’s not that easy.**

So, as with economic events, the outlook for profitable market forecasts is bleak:

- If you make a conventional, status quo-type forecast, you're likely to be right most of the time.
- But since the status quo usually is shared widely and factored into prices, a status quo forecast won't help you beat the market or call its turns (even if it's right).
- The forecasts with real profit potential are the ones that correctly predict unusual events.
- But idiosyncratic forecasts are wrong most of the time (and thereby unlikely to be profitable).

So if (a) conventional forecasts are easy to make correctly but generally lack profit potential, and (b) unconventional forecasts have theoretical profit potential but are hard to make correctly, then (c) it should be clear that forecasts are unlikely to help you know enough about the future to beat the market.

Does Anyone Point Out What The Consensus Doesn't Know?

I feel very strongly that the hundreds of economists and strategists with conventional forecasts add little to the equation. On the other hand, Byron Wein of Morgan Stanley is one of the small group who provide a very valuable service by consciously looking for surprises (and who knowingly accept the risk entailed in talking about things that probably won't happen). At the beginning of each year Byron publishes a list of ten things that most people feel won't happen but he thinks have a 50% or better chance of taking place.

Here are some examples regarding 2003:

- The stock market gains 25%, largely due to foreign support.
- The economy shows 4% real growth, causing the 10-year Treasury yield to jump to 5.5%.
- Japan gets serious about fixing its problems, and the Nikkei soars to 11,000.
- Saddam steps down, Kim Jong Il negotiates, and we avoid major military action.

None of these things seems highly likely. **But that's the point:** if they seemed likely, they wouldn't be on the list of things the consensus has dismissed. And they would be factored into market prices. What Byron does for us is (a) call attention to some things to watch for and (b) perhaps more importantly, remind us that the things that move the market are the surprises . . . although maybe not these. I commend his list to your attention; **it's all about what investors (and certainly the consensus) don't know.**

And by the way, Byron performs an additional service each year: he reprints his year-earlier list and lets us assess which ones came true. Most years, a few have materialized, but there was no way to know in advance which ones. In retrospect, half of his calls regarding 2002 look quite impressive:

- No major terrorist event occurs in the U.S.
- Early strength in the U.S. economy proves short-lived.
- The yield on the 10-year Treasury drops below 4%.
- Japan's recession continues.
- Pension fund solvency becomes a major issue.

On the other hand, these don't:

- Iraq refuses to admit inspection teams.
- People start traveling again; airlines and hotels prove rewarding investments.
- Technology and telecom equipment orders improve.
- Post-Enron populism sweeps the U.S.; Democrats take control of both houses of Congress.

Byron's list shows us that (a) it is possible to predict some coming surprises, but (b) it isn't possible to do so with high reliability. Thus it's not clear that betting on his list of potential surprises – or any such list – would be profitable.

Here's A Non-Consensus Forecast for You

If you're looking for an idiosyncratic, non-consensus forecast to make some money on, see Robert Prechter. As the February issue of "Bloomberg Markets" magazine stated:

Forget about the Dow Jones Industrial Average returning to 11,000. Try Depression-era levels of less than 1,000. And don't flock to bonds for safety: Municipalities will default and corporate bonds will be wracked by downgrades. Even the U.S. government's credit status may sink low enough to make Treasury bills shaky.

You've heard of extreme sports; Prechter's recent record probably represents the norm for an extreme forecaster. He joined the pantheon of famous forecasters by being right the obligatory once in a row (but in a big way): he predicted a crash two weeks before October 19, 1987 made him right. Then, according to Bloomberg, "he missed the almost decade-long bull market." And he hasn't changed his spots since. **"I'm once again calling for events that few expect," he says.** "His work is as relevant now as it ever was," says Henry Van der Erb. "A quack," says Michael Thorson.

And that's the point. **His forecast certainly is non-consensus, and if you follow him and he's right, you'll make a fortune (or at least avoid losing one). But who'll follow him?** As I wrote in "The Value of Predictions II,"

It's difficult with regard to a non-consensus view of the future (1) to believe in it, (2) to act on it, (3) to stand by it if the early going suggests it's wrong, and (4) to be right.

How much do idiosyncratic forecasters like Robert Prechter really know about the future? How much can their forecasts help you to know? And how much are you willing to bet on their being right?

Reliance on Weak Data

Investment experts love to dredge up data supporting their observations, and ever since computers began to be applied to the stock market in the 1960s, a remarkable number of phenomena have been discovered and documented. On December 11, the Wall Street Journal went into detail concerning "the so-called January effect – the tendency of certain stocks to rise in January after money managers tweak their holdings for tax purposes."

Okay, that makes sense. **Everyone knows** stocks usually do well in January. But since it's no secret, by now people should have learned to buy stocks ahead of the phenomenon, and that should have negated it. As I wrote in "Etorre's Wisdom," if everyone moves into the fast lane, it'll stop being the fast lane.

But let's say there is a January effect. My favorite part of the Journal article was where it suggested that in 2002 people should wait until the end of December to buy, rather than entering the market sooner. The reason: while December's usually a strong month, in 2002 a "statistical wrinkle" had the potential to make it a weak month instead. "In more than half the 21 instances since 1897 when the Dow Jones Industrial Average fell by 10% or more in the first 11 months of the year – it was down 11.2% this year – December was a weak month."

Sounds astute, right? But wait. First, the data reaches back to 1897, and I'm not sure 100-year-old observations are relevant today. Second, this set of facts has applied only 21 times in history, and that's not much of a sample. Third, what's the significance of "more than half"? If I told you a roulette wheel had come up black in 12 or 13 out of 21 spins, would that make you bet the ranch on black? I doubt it. If I told you it was 20 out of 21, that might make you consider it. And if it had been black 60,000 times out of 100,000 spins, you might race to the table (and find me there).

So what did happen to the January effect that "everyone knows about"? On February 3 the Wall Street Journal reported:

. . . The Dow Jones Industrial Average finished [January] with a 3.5% drop.

That is an inauspicious beginning to the year, doubly so because it follows a 6% decline during December. Historically, December has been the strongest month for stocks, with the industrial average rising in 72% of the Decembers since 1900.

A back-to-back December-January decline is rare; it has happened only 9 times since 1900.

In five of those nine years, the market fell after the January fizzle.

So now the bullish January effect is discarded, and the bearish December-January effect demands our consideration. What has the Journal proved? That we can no longer count on the January effect? That it's bad to hold stocks when both December and January show declines? Neither of these, I think. **What's been proved is that more data doesn't necessarily mean more information.** The Journal suggests the December-January rule as a guideline for managing money, but I wouldn't bet a penny on something because it happened five times out of nine. (After all, if you flip a coin nine times, it has to come up at least five times on one side or the other.)

For another example, my attention was drawn to the graphic accompanying the Journal story, titled "What Happens to Stocks When the U.S. Goes to War." It said, "The stock market has generally weakened while anticipating war, but rebounded strongly when fighting proceeded." Do you really think a meaningful inference can be drawn from something that's happened four or five times in a century? Should people trade on it? And if not, why run the story? Who's helped?

I think statistics are like matches – the unsophisticated shouldn't play with them. When shown to the public, they tend to produce confusion between possibility, probability and a sure thing, and between random occurrence and cause-and-effect.

I Know a Good Thing When I See It

In “Lessons from Distressed Debt” I referred to Warren Buffett’s observation that, in the short run, the market’s a popularity contest. And since anyone can tell a good company from a bad one, it should be easy to predict the winners of the popularity contest and rack up above average gains.

The CFA Digest is a publication of the Association for Investment Management and Research that provides two-page summaries of scholarly articles, and one-paragraph summaries of the two-page summaries (making it very useful for busy people). The November 2002 issue reviewed an article from the Journal of Financial Research entitled “Are the Best Small Companies the Best Investments?” It cited eleven annual surveys of the “best” small companies that ran in Business Week from 1985 to 1995.

As the article shows, these surveys were of absolutely no value – check that; negative value – in the search for stock market profits. Whereas the stocks of the chosen companies had far outperformed a couple of stock indices in the three years prior to the surveys, they underperformed in the three years following publication.

In sum, the authors show that investing in stocks subsequent to their appearance in Business Week’s “100 Best Small Companies,” on average, provides negative excess returns relative to the benchmarks. The authors identify mean reversion of corporate operating performance, overly optimistic growth projections, and the bidding up of the prices of growth stocks to unrealistic levels as potential factors in this underperformance. The authors conclude that “any attempt to find winning investments from a ‘hot growth’ listing . . . appears futile.”

So, I ask: what do you know about which companies are the best, and what does that tell you about your ability to profit from that knowledge?

Help Is On the Way (Or Is It?)

For several months now, investment forecasters have been in the news – but not in a favorable sense. The New York Attorney General, the SEC and the NASD have been all over Wall Street brokerage firms and their analysts for their part in the tech/media/telecom craze of the late 1990s.

As everyone now knows, there was little or no “information” in many leading analysts’ profit forecasts, target prices and buy/sell recommendations. Profit forecasts often represented little more than regurgitation of what management said. Target prices tended to be the levels analysts thought stocks might reach (as opposed to what they thought was merited). And many of the “buy” recommendations turned out to have been made to garner investment banking business, not to make money for brokerage clients.

The remedies that prosecutors and regulators have arrived at are (a) to further separate the firms’ research function from investment banking and (b) to require brokerage firms to buy independent research for their retail customers. I have some serious questions about whether the latter will produce the hoped-for result:

- Will research boutiques with the best information provide it to retail investors? Will the top research shops want to communicate their information via the massive brokerages (and thereby sacrifice its uniqueness, and their relationships with institutional investors)?
- Will retail investors (or the brokerages on their behalf) be willing to pay top dollar for the best research? Or will it continue to go to institutional investors, with individuals getting the dregs?
- If independent research providers earn big dollars by selling their research to the Wall Street giants, will they remain insulated from the investment banking considerations that affect their new customers?
- The regulators want brokers to provide independent buy-hold-sell advice. Can a blanket recommendation be right for everyone?
- What chance is there that individual investors will gain access to and read the analysis behind the buy-sell recommendations? And make sense of it?
- **Can anyone really produce research capable of helping investors achieve stock market profits?**

As one observer noted in The New York Times of December 23, “What’s amazing about this settlement is that the investor will continue to get something for nothing, which is why we had these scandals in the first place.” In other words, **investment research stopped being about investors when commissions became unfixed and providing research became unprofitable.** It was when commissions became negotiable and payments for research dried up that the firms started thinking less about their brokerage customers and more about investment banking. What’s changed?

How Might the Regulators Help?

There are numerous obstacles to equipping retail investors with the tools they need to invest safely and well. I feel most strongly that the answer doesn’t lie in giving them “independent research” that has been blessed and thus is likely to once again be overly depended on and just a new source of pain. **Instead, the regulators should make sure investors are educated as to (a) the requirements for successful investing and (b) the severe limitations on forecasts and recommendations.** Brokerage firms are aided when investing is made to look easy and safe, but their customers certainly are not.

On December 21, The New York Times carried an article about Jack Grubman, who seems to be the poster boy for analyst malfeasance. What caught my eye, however, was the quote from Henry Hochman, 88, who lost almost \$10.7 million on WorldCom. “I’m broke. I have to start saving pennies now. I can’t live the way I was accustomed to living. It has affected my health. Smith Barney told me this was the best of the telecom companies. Whatever Grubman wrote sounded very good.”

Of course, Grubman and Smith Barney are far from without fault in this matter, but Mr. Hochman made his own mistake (although likely not unaided). From the fact that he had \$10.7 million to lose, we might guess that he had been an astute businessman. So what was he doing, in his late eighties, investing enough in growth stocks – and in a single stock – to wreck his financial world? If he didn’t know this was a dangerous course of action, someone should have told him so.

I’m not saying it’s the regulators’ job to provide this education. But if they’re going to get tangled up in the investment process, **I’d rather see them talk about what you can’t know than what you**

can. In other words, don't give investors new forecasts that they'll count on to lead them to sure profits. Tell them there's no such thing. That would be a public service! Most thoughtful, unconflicted observers think the average individual investor is better served through long-term investment in mutual funds, and index funds at that. That's the message he or she should be given.

Hey, Get Yer Free Information!

I've talked about the strategists, economists, analysts and money managers whose views are available free in brokerage house reports and in the media. The bottom line for me is that on balance they don't contribute much. Some are right in a big way once in a while, but not often enough to be dependable. Others are a little right a lot of the time, but they usually agree with the consensus and extrapolate current conditions, and thus they add little value.

The statistics are clear. There just isn't any evidence that many managers can beat the market in the long run, or that many of the professionals who profess to know the future actually do.

But there's another test that's even easier: **if the forecast is correct, why is it being given away?** Nothing could be more valuable than correct information about the future. Given the leveraging power of futures and options, anyone who saw the future correctly could become a billionaire in no time. So when you see a forecast available gratis, I suggest you ask yourself, "Why is it being given to me?" Having made that inquiry, I doubt you'll end up doing what the pundit said to do. As usual, Warren Buffett has put it clearly:

There's no reason in the world you should expect some broker to tell you whether you can make money on index futures or options or some stock in two months. If he knew how to do that, he wouldn't be talking to investors. He'd have retired long ago. (Money, Fall 1987)

Or, putting it a little more bluntly:

Wall Street is the only place that people ride to in a Rolls-Royce to get advice from those who take the subway. (Los Angeles Times Magazine, April 7, 1991)

* * *

I guess I've made it obvious how little I think of the "I know" school. Its members simply do not know all they think they do.

Most congenital bulls – who seem to be the norm among big-stock devotees – make a ton when the market soars but give it back in the bad years. The few congenital bears avoid participating fully in down markets . . . and up markets as well. And most active managers buy and sell at a furious clip, implying they know a lot. Yet I'm aware of few people who have beaten the market consistently by correctly timing its ups and downs, or by picking among the stocks that everyone follows.

It might be exciting to manage money by adroitly timing exposure to the stock market, predicting which industries will do best, and holding only the stocks that will go up the most. But my ten years in equity research (and 25 years since as an observer) have taught me it's a fool's game. Massive

amounts of brainpower and computer power have been devoted to the task, but **there's no evidence it can be done.** (In that connection, you might be interested to know how many profitable funds there were in 2002 among the 100 equity funds that P&I says are most used by defined contribution plans: **none!**) It wasn't for nothing that when I left equity research in 1978, I told Citibank "I would do anything but spend the rest of my life choosing between Merck and Lilly."

So I'm a card-carrying member of the "I don't know school." Not because it makes life more fun, but because it provides guidelines for working within the limitations of an intelligent, highly competitive market.

When I was a kid, my mother often taught me through adages. One of the best went this way:

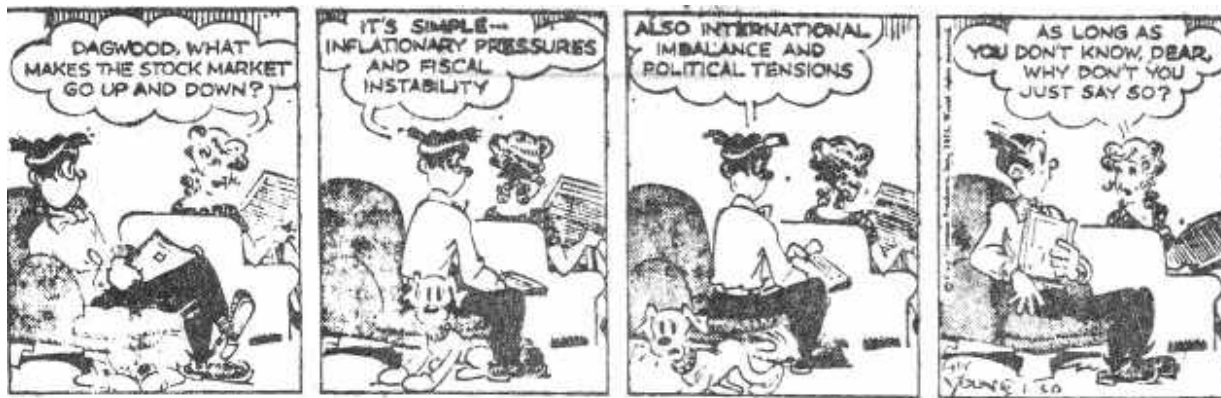
He who knows not and knows not he knows not is a fool; shun him.
He who knows not and knows he knows not is hungry; teach him.
He who knows and knows not he knows is asleep; wake him.
But he who knows and knows he knows is wise; follow him.

Overestimating what you're capable of knowing or doing can be extremely dangerous – in brain surgery, cross-ocean racing or investing. As Dirty Harry said, "A man should know his limitations." **Acknowledging the boundaries of what you can know – and working within those limits rather than venturing beyond – can give you a great advantage.**

At Oaktree, we believe that because there's so much we can't know about the future, we should invest only where our analysis tells us the worst case is tolerable. We try to avoid situations that entail high expected returns but also a meaningful chance of being wiped out. Peter Bernstein put it simply but elegantly in "Economics and Portfolio Strategy," January 1, 2003:

In making decisions under conditions of uncertainty, the consequences must dominate the probabilities. We never know the future.

Or perhaps Blondie's take was the most profound:



circa 1973

March 11, 2003

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Memo to: Oaktree Clients
From: Howard Marks
Re: What's Going On?

In recent months, a few Oaktree clients have asked me to take part in give-and-take sessions with their investment staffs and other money managers. The discussions have revolved around changes in the investment environment and the implications for the future. The process of thinking about those subjects has given rise to this memo.

A Sweeping Change

In the last three years, there have been massive changes in markets, investment thinking, expectations and behavior. The term "paradigm shift" certainly is overused, but in this case I don't think it's off target.

During the 1990s and for many years prior, institutional investors such as pension funds and endowments targeted returns of 8-10 %. The task of appropriately allocating assets was made easy by the universal expectation (accompanied by sixty-plus years of supporting data) that stocks "normally" return 9-11 % per year. When the main engine of a portfolio's performance can be counted on for returns that exceed what's needed overall, asset allocation is a relatively easy task. Put a substantial majority of the portfolio in stocks, add a few bonds in a nod to conservatism and an allocation to private equity for spice, and the job's done.

The only question was what you wanted your return to be (within the range of 8-10%), and the solution was found in the magnitude of your equity allocation. Certainly, overall portfolio returns in the range of 8-10% were viewed as readily attainable.

But all of a sudden, no one thinks so anymore. Goals at that level (or even a little lower) now seem quite daunting. What has changed is the equity return people feel can be expected. History is out the window, and few people believe any longer in 9-11% from equities. Moderates talk about long-term returns between 4% and 8%, and the bear case is considerably lower (or negative). With high grade bond yields also in the low to mid-single digits, the two biggest asset categories are promising returns that fall short of the overall goal. Thus it's unclear how that goal can be achieved while holding any meaningful amount in stocks and/or high grade bonds – or whether it can be achieved at all.

We all know what happened to prospective bond returns: economic weakness and the Fed's stimulative actions combined to lower prevailing interest rates, and thus promised bond returns, to 40-year lows. But what happened to the prospective return on equities?

Simply put, people began to search for the elements that would lead to continued lofty equity returns, and they failed to find them. In the 1990s, few people pondered the fact that if corporate profits grow in single digits and "normal" equity performance is 9-11 %, two decades or so of returns almost twice that might be borrowing from the future. Now the future is here and that realization has set in. Those single digit profit increases (accompanied by low dividend yields) are expected to result in mid-single digit equity returns if P/E ratios are unchanged, and less if multiples shrink.

So the question has switched from "How much would you like to make and spend?" to "How much can you make safely, and what will that let you spend?"

Is There No Opportunity in Equities?

It is clear that (a) most people's expectations for equities now are in the mid single digits, and (b) equities are attracting as little interest as at any time in the last 25 years. There are, however, factors supportive of a more positive case:

- The most obvious is the fact that stock prices are off substantially since hitting record highs in early 2000.
- Another positive might be seen in the fact that the curtailing of expectations for equity returns coincided with the incurrence of substantial losses. Thus it's tempting to think that the moderation of expectations may have stemmed from the corrosive emotional effect of recent losses on investor psyches, not from new data or objective analysis.
- In fact, it's comforting to note a hopeful analogy. In August 1979, after a harsh correction in 1973-74 followed by several sluggish years, the cover of Business Week proclaimed "The Death of Equities" . . . just prior to the ignition of the historic bull market that lasted through 1999. As in that case, with attitudes toward equities beaten down so universally, the contrarian position today might be to bet heavily on them. Sentiment toward equities can hardly get worse and, unimaginable as it seems, it just could get better.

At the same time, there are negatives to be dealt with:

- Even though stock prices have come down substantially, the average P/E ratio remains high – in the upper teens or low twenties, depending on whom you ask. In the last major cycle, which bottomed in the 1970s, P/E ratios reached levels like today's at the high and fell to single digits when prices hit bottom. By that standard, today's valuations suggest a high, not a low.
- One reason today's P/E ratios are high in the absolute is that interest rates are so low. Low interest rates justify a high valuation of future cash flows. But what

does that imply for P/E ratios (and stock prices) if interest rates were to rise from today's historic lows?

- Lastly, we have to wonder where the energy for a more bullish market will come from, and specifically whether a generation of investors who've been burned is lost from the stock market forever.

My own take is that even if the 9-11% historic long-term return on stocks remained relevant with regard to the future, (and certainly that's the best anyone could hope for), the above-average gains of the last two decades have borrowed from the future, and the high resulting P/E ratios imply an average return in single digits over the next few years.

At the same time, I think some good individual opportunities may be found among orphaned small and mid-cap stocks. Because investment banks are no longer supposed to recommend stocks just to get investment banking business, their coverage lists might contract. The financial pressures and resulting layoffs at the big research firms are leaving many companies without coverage. Many un-researched companies will likely emerge from financial restructurings and corporate spin-offs. Put it all together, and expert stock pickers probably will find some good opportunities in the newly less efficient market.

The Market Cycle at Its Wildest

In a memo on cycles entitled "You Can't Predict. You Can Prepare." I discussed the general progression of a market cycle:

- Favorable developments and positive investor psychology cause prices to rise.
- Reports of price appreciation attract momentum players, who shout, "We'd better get in; who knows how far this can go." Their purchases of already-appreciated assets move prices still higher on a trajectory that appears capable of rising forever.
- Eventually, prices get so high that they vastly exceed intrinsic values.
- A few value-conscious investors step into the crowd to sell. Prices turn down, sagging under their own weight or perhaps because fundamental developments begin to be less favorable.
- Less-favorable developments and less-favorable psychology combine to force prices below intrinsic values.
- The pain of losses becomes so great that investors flee and prices reach giveaway levels. This time it's, "We'd better get out; who knows how far this can go."
- The first iron-nerved contrarians recognize that good values are available and start to buy.
- Others soon follow, and eventually the number of new buyers exceeds the number of sellers. Prices stop falling . . . and begin to rise.

- Reports of rising prices and the bargains obtained by those astute pioneers attract the masses to the marketplace, who shout, "We'd better get in . . .," and the cycle continues.

I've always known about this cycle. I've seen it at work for decades. **But I've never seen it function – in terms of the extent and swiftness of the fluctuations – as it did with regard to low-grade debt over the last year.** Because the performance of mainstream equities has little direct impact on Oaktree, we remain largely disinterested observers of stock market developments. But we are vitally interested in what happens in credit-related investments, and the change there has been mind-boggling.

The Pricing of Credit Risk in 2002-03

It's hard to believe, but the biggest cycle I've ever seen in distressed debt began just about a year ago.

- With investors softened up by economic sluggishness, depressing world events and the realization of just how wrong they'd been in the 1990s, conditions were ripe for a crisis of confidence. The catalyst came in the form of an incredible series of corporate scandals.
- At first, Enron was viewed as an isolated instance of corporate venality. But then Tyco, Adelphia and Global Crossing began to suggest a pattern. Arthur Andersen was convicted and had to shut down. The capper was the disclosure of massive fraud at WorldCom. Billions were lost, confidence was dashed, and investors – so certain just a year or two earlier – no longer felt they had a foundation on which to base any confidence.
-
- Bond fund managers who thought they had bought money-good securities found themselves holding distressed debt. Bonds they felt good about buying at prices of 90 or 100 turned scary at 20 or 30. High grade bond managers sold downgraded bonds (or bonds expected to be downgraded) as required or to dress up their statements, and everyone sold to reduce concentrations, raise cash to meet withdrawals, or cut risk.
-
- Because of this combination of events, we were able to invest more than \$2 billion last summer in distressed debt priced very attractively. We put massive amounts into the public bonds of sizeable corporations – like Tyco, Qwest, Lucent, Nortel and Corning – that we thought might pay interest and principal as promised. In the past, we've always thought our distressed companies were 99% likely to default or go bankrupt. Now we were paying death's-door prices for bonds that we thought had a good chance of escaping that fate.

In this way, the downswing of the distressed debt market cycle gave us unusually good investment opportunities: significant companies that might survive, giveaway prices,

potentially high prospective returns, in vast quantities. We were buying at yields well above 20%, and total returns that we thought would be far higher if our credit judgments were validated. We felt our purchases in June-September 2002 rivaled those of 1990, which had produced our highest returns to date.

But the most amazing thing is what happened next. The market turned on a dime, and in the next six months it became as strong as it had been weak.

What caused the turn? Maybe it was the fact that scandals stopped erupting. Maybe it was the first few successful sales of assets made to improve balance sheets. Maybe investors realized that distressed debt offered excellent investment opportunities. Maybe distressed debt fund managers regretted having missed a major opportunity to invest during the summer. Or maybe it was Warren Buffett's announcement that Berkshire Hathaway had increased its holdings of lower-rated debt by \$6 billion in 2002. Whatever the reason, sentiment turned from negative to positive . . . with a vengeance.

Based on data for the OCM Opportunities Fund IVb, the distressed debt positions we bought in 2002 returned almost 20% in November alone, and 23% in the fourth quarter of the year. They took off again in early 2003, rising 15% in the first quarter and another 10% in April. For the six months from November through April, the total estimated gain has been more than 55% (and more than 41% net of fees and expenses).

This was yet another example of the schizophrenic swing of the investment pendulum: Trust replaced skepticism. Gain replaced loss. Greed replaced fear. And, incredibly, panic buying replaced panic selling. The cycle had swung from morosely negative to ebulliently positive in less than a year. **And thus the Tyco bonds we bought in May 2002 at a 24% yield became gilt-edge securities that could be sold in January 2003 – at yields of 4%-plus.**

We've seen the same cycle in high yield bonds. Last July, because investors had developed allergies to high yield bonds, the average bond had to provide more than 1,000 basis points more yield than a Treasury note of comparable maturity to induce investors to buy it. But now, investors have come to lust after high promised returns, and they are willing to buy the average high yield bond at a spread of just 600 basis points or so. The resulting estimated net return on our high yield bond portfolios: more than 15% for the 6 months November through April.

But Why?

Most observers are familiar with the returns reported above, and with the changed attitudes toward credit risk that lie behind them. But I think the behavior of distressed debt and high yield bonds should be viewed in a broader context, not in isolation. There are big-picture influences behind these trends.

What happens when people get excited about an asset class?

- capital floods in,
- prices rise,
- current returns soar, and
- prospective returns decline.

But don't forget the significant ramifications. Investors lose interest in other asset classes; thus their prices fall (at least in relative terms) and their prospective returns rise. In other words, the popular asset becomes more expensive and the rest get cheaper.

A powerful cult of equity believers held sway from 1978 – when I started to manage portfolios – through 1999, with only minor interruptions. The average return on the S&P 500 was over 17%. There wasn't a year in which the index declined more than 5%. Equity managers and analysts showed up on magazine covers and TV screens. Equities were fawned over in books ranging from "Stocks for the Long Run" (which explained that stocks could be counted on to beat bonds, cash and inflation in any period, providing it was long enough) to the self-explanatory "Dow 36,000." The man on the street accepted stocks as a sure thing.

What both the man on the street and the investment professional missed was that the appreciation that powered stocks' record returns had borrowed from the future and made them very expensive. And the view that stocks were all you needed also implied that other assets were superfluous. Thus bonds went out of favor, at least in relative terms. In the 1990s, few of the people I met could think of a convincing reason for their fixed income allocations. Maybe that made bond yields and yield spreads more generous than they should have been. **Stocks in favor and rich; bonds out of favor and cheap.**

And since the beginning of 2000? Stock prices are down. Confidence in stocks has been dashed. Equity return expectations have collapsed. Bonds and their contractual returns suddenly seem more attractive. Bond prices are up. Credit spreads have narrowed. The proof is seen in the performance described above.

The Power of Capital Flows

I want to discuss one last element that's been behind the powerful appreciation we've seen recently. I think the explanation's easy.

In the long run, investing is about value and the expectation that, eventually, price will catch up. But in the short run it's about psychology, emotion and popularity. The influence of those three factors comes through their effect on flows of capital, and **in the short run it's capital flows that have the most profound impact of all.**

The equity market is huge: \$8.6 trillion in the U.S. alone. The high yield bond universe is about a tenth that size, and distressed debt is a fraction of that tenth. When a few

billion dollars were withdrawn from stocks, the effect was moderate. But when those same refugee dollars sought deployment in our niche markets, the impact was dramatic.

In the last few months, what had been a buyers' market has become a sellers' market. Last year, especially in distressed debt, it was "the more money, the better." Now it's the opposite.

In the long run the return on an investment will follow the fundamentals, and in that sense I think of it as something approaching a fixed-sum proposition. But market fluctuations will render the receipt of that return highly uneven, as price moves above and then below intrinsic value. **Thus, everything else being equal, a higher return to date means a lower return in the future.** In this way the recent increase in bond prices implies lower bond returns in the future, and the narrowing of yield spreads implies lower relative returns for lower-rated bonds. A manager of lower-rated bonds hates to have to make these admissions, but refusing to make the admissions wouldn't make them any less true.

The Cat, the Tree, the Carrot and the Stick

I hope you'll forgive an incredible mixing of metaphors, but I can't resist using one to sum up on the subject of the current investment environment. As I think about situations like today's, (which, by the way, is not unprecedented), I visualize a cat in a tree. A carrot lures him out onto increasingly higher branches, and a stick prods him from behind.

In my analogy, the cat is an investor, whose job it is to cope with the investment environment, of which the tree is part. **The carrot – the incentive to accept increased risk – comes from the high returns seemingly available from riskier investments. And the stick – the motivation to forsake safety – comes from the modest level of prospective return being offered on safer investments.**

The carrot lures the cat to higher branches – riskier strategies – in pursuit of his dinner (his targeted return), and the stick prods the cat up the tree, because he can't get dinner while keeping his feet firmly on the ground. And that's a pretty good description of today's investment environment.

Today the greatest carrots are perceived to be available in the high yield bond and distressed debt markets. Not only do they make sense as ways to play the economic recovery that is presumed to loom ahead, but also they have provided the best recent results. **Of course, many cat-like investors fail to realize that excellent recent results don't add to an investment's prospective return; rather, they detract from it.** But the carrot of high recent results never fails to attract new followers to a strategy.

And, of course, the stick is extremely powerful today, because any substantial allocations to high grade bonds (with their promised returns of 4-6%) or to equities (whose

prospective returns aren't perceived to be much higher) seem likely to ensure that a portfolio with a targeted return of 8-10% will fall short.

So investors consistently climb out on the limb of whatever strategy has performed best lately, without noticing their increasing distance from the ground. **Risk never looks like risk when it's generating a high return.**

Today that hungry cat is looking for a free lunch (oh no, not another metaphor!) in high yield bonds and distressed debt. **Those markets may offer the best way to be well-fed today, but they should be pursued only with eyes wide open concerning the altitude to which one is venturing.**

What else is there to do? It may sound like heresy, but what about concluding that (a) under what appear to be today's revised circumstances, pursuing that high-up dinner is just too risky, and (b) investors should content themselves with what's available, with safety, on limbs closer to the ground? Am I being too oblique? Let me stop trying to extend the metaphor and put it simply: investors may have to consider lowering their target returns.

* * *

In recent times we've had several reminders regarding the inevitability of the market pendulum's swing, the propensity of investment popularity to wax and wane, the extremes of fluctuations, and the dramatic influence of cash flows. Some years, these transient influences will benefit us, as they have this year. Other years they're sure to hurt.

We can try to cope by understanding where the pendulum stands at a point in time and striving to anticipate its future swings. Or we can put our energy into emphasizing long-term value under the assumption that we'll be able to ride out the fluctuations if we're right about the values. To help us deal with the short-run developments, we've chosen to do some of each in the affected areas.

- We're being very candid about market conditions.
- We're limiting our assets under management.
- And if market conditions don't take a turn for the better, our clients should expect a reduced ability to profitably employ capital in our markets.

As to the long run, we're confident our adherence to value investing will continue to get us through.

May 6, 2003

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Memo to: Oaktree Clients
From: Howard Marks
Re: The Most Important Thing

As I meet with clients and prospects, I repeatedly hear myself say, “the most important thing is x.” And then ten minutes later it’s, “the most important thing is y” (and then z, and so on). Am I being disingenuous? Am I confusing the unimportant with the important? Is it that I can’t make up my mind? Or is memory loss setting in?

I hope (and believe) it’s none of these things. If I have to come up with an explanation, maybe it’s that I have strong feelings on a lot of subjects. Whatever the reason, I thought I’d collect in one place the precepts that guide Oaktree. Some might be more important than others, but in my view each one qualifies as “the most important thing.” The most important thing – **above all** – is the relationship between price and value.

For a value investor, price has to be the starting point. It has been demonstrated time and time again that no asset is so good that it can’t become a bad investment if bought at too high a price. And there are few assets so bad that they can’t be a good investment when bought cheap enough.

When people say flatly, “we only buy A” or “A is a superior asset class,” that sounds a lot like “we’d buy A at any price . . . and we’d buy it before B, C or D at any price.” That just has to be a mistake. **No asset class or investment has the birthright of a high return. It’s only attractive if it’s priced right.**

Hopefully, if I offered to sell you my car, you’d ask the price before saying yes or no. Deciding on an investment without carefully considering the fairness of its price is just as silly. But when people decide without disciplined consideration of valuation that they want to own something, as they did with tech stocks in the late 1990s – or that they simply won’t own something, as they did with “junk bonds” in the 1970s and early 1980s – that’s just what they’re doing.

During the course of my 35 years in this business, investors’ biggest losses have come when they bought securities of what they thought were perfect companies – where nothing could go wrong – at prices assuming that degree of perfection . . . and more. They forgot that “good company” isn’t synonymous with “good investment.” Bottom line: **there’s no such thing as a good idea regardless of price!**

On the way to work the other day, I heard an “expert” tell a radio commentator

how to invest in today's stock market. "Figure out which industries have been doing best, and pick out the leading companies in those industries. The professionals know which they are, so their stocks will sport P/E ratios that are higher than the rest. But that's okay: do you want the best companies or the worst?" **My answer's simple: I want the best buys.**

The most important thing is a solidly based, strongly held estimate of intrinsic value.

To value investors, an asset isn't an ephemeral concept you invest in because you think it's attractive (or think others will find it attractive). It's a tangible object that should have an intrinsic value capable of being ascertained, and if it can be bought below its intrinsic value, you might consider doing so.

Thus intelligent investing has to be built on estimates of intrinsic value. Those estimates must be derived rigorously, based on all of the available information. And the level of belief in estimates of intrinsic value has to be high. Only if the estimate is strongly held will a manager be able to do the right thing.

If there's no conviction, a drop in the price of a holding can weaken the investor's faith in the estimate and make him fail to buy more, or maybe even sell, just when a lower price should lead him to increase his position. And price appreciation, which under most circumstances should prompt a review of a holding's retention, can tend instead to seduce the investor into raising the target price and possibly buying more.

As expressed by David Swensen of Yale, ". . . **investment success requires sticking with positions made uncomfortable by their variance with popular opinion. Casual commitments invite casual reversal, exposing portfolio managers to the damaging whipsaw of buying high and selling low.**"

You may wonder from time to time about the high level of confidence exhibited by your managers. But bear in mind that the most profitable investments are unconventional, and maintaining unconventional positions can be lonely. When you buy something you think is cheap and then see its price fall, it takes a strong ego to conclude it's you who's right, not the market. So ego strength is necessary if a manager is going to be able to make correct decisions despite Swensen's "variance from popular opinion."

Oh yeah, one last thing: those strongly-held views had better be right. Few things are more dangerous than an incorrect opinion held with conviction and relied on to excess.

The most important thing is investing defensively.

Oaktree follows a clearly defined route that it trusts will bring investment success: **If we avoid the losers, the winners will take care of themselves.** We think the most dependable way for us to generate the performance our clients seek is by avoiding losing investments. We don't claim that this is the only way to invest well; others may choose more aggressive approaches, and they may work for them. **This is the way for us.**

Investing defensively can cause you to miss out on things that are hot and get hotter, and it can leave you with your bat on your shoulder in trip after trip to the plate. You may hit fewer home runs than another investor . . . but you're also likely to have fewer strikeouts and fewer inning-ending double plays. The ingredients in defensive investing include (a) insistence on solid, identifiable value at a bargain price, (b) diversification rather than concentration, and (c) avoidance of reliance on macro-forecasts and market timing.

Warren Buffett constantly stresses “margin of safety.” In other words, you shouldn't pay prices so high that they presuppose (and are reliant on) things going right. Instead, prices should be so low that you can profit – or at least avoid loss – even if things go wrong. Purchase prices below intrinsic value will, in and of themselves, result in larger gains, smaller losses, and easier exits.

“Defensive investing” sounds very erudite, but I can simplify it: **Invest scared!** Worry about the possibility of loss. Worry that there's something you don't know. Worry that you can make high quality decisions but still be hit by bad luck or surprise events. Investing scared will prevent hubris; will keep your guard up and your mental adrenaline flowing; will make you insist on adequate margin of safety; and will increase the chances that your portfolio is prepared for things going wrong. And if nothing does go wrong, surely the winners will take care of themselves.

The most important thing is avoiding bad years.

Preparing for bad times is akin to attempting to avoid individual losers, and equally important. Thus time is well spent making sure the downside risk of our portfolios is limited. **There's no need to prepare for good times; like winning investments, they'll take care of themselves.**

The mantra “beat the market” has been vastly overdone in the last 25 years, when outperforming an index has become the *sine qua non* of good management. But why should this be the case? **Keeping up with the market while bearing less risk is at least as great an accomplishment, although few people talk about it in the same glowing terms.**

At Oaktree we believe strongly that in the good times, it's good enough to be average. In good times, the average investor makes a lot of money, and that

should suffice. In good times the greatest rewards are likely to go for risk bearing rather than for caution. Thus, to beat the averages in good times, we'd probably need to accept above-average risk . . . risk that could turn around and bite us in a minute.

There is a time when it's essential that we beat the market, and that's in bad times. Oaktree and its clients don't want to succumb to market forces in bad times and participate fully in the losses. And because we don't know when the bad years will come, we insist on investing defensively all of the time.

Our goal is to generate performance that is average in good times (although we'll accept more) and far above average in bad times. If in the long run we can accomplish this simple feat (which time has shown isn't simple at all), we'll end up with (a) above-market performance on average, (b) below-market volatility, (c) highly superior performance in the tough times, helping to combat people's natural tendency to "throw in the towel" at the bottom, and thus (d) happy clients. We'll settle for that combination.

The most important thing is facing up to the limits on your knowledge of the macro-future.

Investing means dealing with the future – anticipating future developments and buying assets that will do well if those developments occur. Thus it would be nice to be able to see into the future of economies and markets, and most investors act as if they can. Thousands of economists and strategists are willing to tell us what lies ahead. That's all well and good, but the record indicates that their insights are rarely superior, and it's never clear why they're willing to give away gratis their potentially valuable forecasts.

One thing each market participant has to decide is whether he (or she) does or does not believe in the ability to see into the future: the "I know" school versus the "I don't know" school. The ramifications of this decision are enormous.

If you know what lies ahead, you'll feel free to invest aggressively, to concentrate positions in the assets you think will do best, and to actively time the market, moving in and out of asset classes as your opinion of their prospects waxes and wanes. If you feel the future isn't knowable, on the other hand, you'll invest defensively, acting to avoid losses rather than maximize gains, diversifying more thoroughly, and eschewing efforts at adroit timing.

Of course, I feel strongly that the latter course is the right one. I don't think many people know more than the consensus about the future of economies and markets. I don't think markets will ever cease to surprise, or thus that they can be timed. And I think avoiding losses is much more important than pursuing

major gains if one is to achieve the absolute prerequisite for investment success: **survival**.

The most important thing is being mindful of cycles (and where we stand in them).

We must never forget about the inevitability of cycles. Economies and world affairs rise and fall in cycles. So does corporate performance. The reactions of market participants to these developments also fluctuate cyclically. Thus price swings usually overstate the swings in fundamentals. When developments are positive and corporate profits are high, investors feel good and often bid assets to prices that more than reflect their intrinsic value. When developments are negative, on the other hand, panicky investors are prone to sell them down to overly cheap levels. So prices sometimes represent high multiples of peak prospects (as they did with technology stocks in the '90s), and sometimes low multiples of trough prospects.

Ignoring cycles and extrapolating trends is one of the most dangerous things an investor can do. People often act as if companies that are doing well will do well forever, and investments that are outperforming will outperform forever, and vice versa. Instead, it's the opposite that's more likely to be true.

The most important thing is contrarian behavior.

Because of the fluctuation of both fundamental developments and investor behavior, assets are sometimes offered for sale at bargain prices and at other times at prices that are too high. A technique that works most dependably is putting money into things that are out of favor.

Although investors often seem not to grasp it, it shouldn't be hard to understand: **only unpopular assets can be truly cheap. And those that are in favor are likely to be dear.**

For example, one of the best reasons for the profitability of distressed debt over the years is that there's no such thing as a distressed company everybody loves. By the time they've made their way to our arena, distressed debt companies can no longer be on what I call "the pedestal of popularity." **We buy at low dollar prices from depressed owners at a time when corporate performance is well off from the top. Not a bad formula.** Certainly that doesn't have to mean that the investment's cheap enough, but at least there's a low probability it's pumped up on hot air (or investors' ardor).

The momentum player buys what's up and bets that it'll keep going up. The style devotee buys one thing whether it's up or down. But the contrarian, or value investor, buys something that other people aren't interested in, in the belief that it's cheap and will become less cheap someday. There's no sure recipe for profit,

but I think this one stacks the cards in your favor. **As Sir John Templeton put it, “To buy when others are despondently selling and to sell when others are euphorically buying takes the greatest courage but provides the greatest profit.”**

The most important thing is patient opportunism.

At Oaktree we try to sit on our hands. We don't go out with a “buy list”; rather, we wait for the phone to ring (while we do our research and analysis). If we call the owner and say, “You own x and we want to buy it,” the price will go up. But if the owner calls us and says, “We're stuck with x and we're looking for an exit,” the price will go down. Thus, rather than initiating transactions, we react opportunistically.

One of our mottos is “we don't look for our investments; they find us.” In general, that means investing from the bottom up, not from the top down – from the list of things that are available cheap, not in things we think it'd be great to have a position in. When you're a top-down investor, you predetermine that a given percentage of the portfolio should be invested in a certain sector, and then you proceed to look for the best bargains in that sector. The bottom-up investor has no such preconception; he looks for the best bargains, regardless of where they can be found. Sector allocation falls out largely of its own accord (but hopefully with concentrations held to tolerable levels).

The most important thing is saying what you'll do, and doing it.

The world of investing – where we deal with an unknown future – is filled with vagaries. Trying hard will take you only so far; no one is wise enough to get it right every time; and even the most well-intentioned manager will make mistakes on occasion. Therefore, if you're going to have successful relationships, effort, wisdom and good intentions aren't enough. A relationship also needs a solid foundation.

In my opinion, that foundation comes best when managers tell clients exactly what they can do and will do . . . and then do it. Managers should be aware that usually they're not hired to pursue profit any way they can think of. Instead, it's to play a specific role in the client's manager lineup and impart specific attributes to the portfolio. Promising too much, or doing things outside one's charter, are surefire means to unhappiness.

If every manager described his or her activities in explicit terms, and then stuck entirely to what had been described, the vast majority of problems between managers and clients would be avoided.

The most important thing is preserving investment flexibility.

This sounds like a good idea, but of course it can be the polar opposite of the explicitness recommended above. Given that it's impossible to know what the future will look like, however, it can be unwise to define too narrowly the tactics and strategies you'll apply.

Clients want managers to be specific so that they'll know what to expect and have a high probability of getting what they signed on for. But excessive specificity can hamstring the manager. How can these two points be reconciled?

In our funds over the years, we've made numerous successful investments that weren't foreseen when the funds were formed. **I think the key to bridging this gap is to be very specific about your philosophy, goals and investment style, and to restrict as little as possible the specific strategies and tactics you'll employ.**

Once a manager has earned the trust of his (or her) clients, he may be granted leeway to change tactics so as to be able to adapt to changing market conditions. And clients can be confident that they'll get the investing style they want without limiting the tactics used to get it. **In the end it should be borne in mind that there must be flexibility in order for a manager to be able to act opportunistically, and opportunism (applied skillfully) is an absolute necessity if one expects to keep up with changing market conditions.**

The most important thing is refusing to manage too much money.

The investment management business is plagued by a dilemma: **Good performance can bring more money, and too much money can bring bad performance.**

There, I've said it!! – at the risk of being thrown out of the money managers' union. All managers want to manage more than \$1, or \$1 million, and so they grow their assets. And certainly the first dollar of growth doesn't doom performance to mediocrity. **But it absolutely cannot be argued that there isn't a point at which incremental capital causes performance to decline.**

One of my favorite incidents occurred when our local charity's investment committee was looking for a new manager. When I asked one candidate whether his firm had a limit on assets under management, he said, "We don't see any reason for a limit." But when I asked why their relative performance had declined precipitously in recent years, he said, "Well, we used to manage a lot less money." Less than insightful, I think (and he didn't get the job).

I can assure you that turning away money is the hardest thing for a manager to do, but it's also one of the most important. For the last twenty years we've put limits on our strategies and turned away money, and we're extremely glad we did.

The most important thing is understanding the implications of market efficiency.

I believe strongly that some markets are quite efficient, meaning the collective actions of informed, diligent investors tend to make assets in those markets sell where they should. Assets become priced such that their prospective returns are fair relative to the perceived risk – but only fair. Clearly, if assets are priced fairly, it's hard to find bargains. And if it's hard to find bargains, there's no reason to go to the trouble (and expense) of active management. **In efficient markets, few investors are capable of regularly outperforming the benchmarks and each other, and the range of investor performance is quite tight.** In mainstream, large-capitalization stocks, for example, the management fees and transaction costs entailed in active management don't seem to be earned back with any regularity.

But I also believe in the existence of relatively inefficient markets. In these markets, information may not be disseminated evenly; investors may not be objective or many in numbers; and uncommon expertise may be required. Under these circumstances, assets can be mispriced relative to their intrinsic value, relative to their risk, and relative to each other. And discernible mispricings are a necessary condition for profitable active management. **Only if mispricings exist such that they can be exploited by skillful managers can consistent outperformance be possible.**

Finance theory holds that because it takes higher prospective returns to induce investors to make riskier investments, risk and apparent prospective return must be correlated. It also holds that since investors can't add to returns through active management, the only way to increase returns is by accepting more risk. This makes great sense with regard to markets that are efficient. **And it highlights a final attraction of less efficient markets: that risk and return need not be so perfectly correlated. Thus, in inefficient markets, "low risk" doesn't have to mean "low return." In fact, I think our team's greatest accomplishment is having demonstrated over a long period of time that low risk and high returns can go hand in hand (and, in fact, that low risk can lead to higher returns).**

Because of my views on market efficiency and its ramifications, I made a conscious decision 25 years ago to work exclusively in markets I believe are inefficient. It's there that hard work and skill can pay off dependably. Common sense (and the record) suggest that if investors are going to earn superior risk-

adjusted returns, it's not likely to be by doing the same things everyone else is doing. **The best and most safely earned profits are apt to be found outside the mainstream, not inside.**

The most important thing is being leery of leverage.

The key elements in Oaktree's investment approach include focusing on what's out of favor; ascertaining intrinsic value and trying to buy for less; and adding value by working with assets once we own them. **If done well, these things can simultaneously increase prospective return and reduce risk. Leverage, on the other hand, increases prospective return and increases risk.**

There's nothing magic about leverage. It increases upside potential, but it also reduces or eliminates the margin of safety. Leverage is just an application of the Las Vegas maxim, "The more you bet, the more you win when you win." But I think people tend to omit ". . . and the more you lose when you lose."

As Warren Buffett puts it, "It's a very sad thing. You can have somebody whose aggregate performance is terrific, but they have a weakness – maybe it's alcohol, maybe it's susceptibility to taking a little easy money – it's the weak link that snaps you. **And frequently, in the financial markets, the weak link is borrowed money**" (emphasis added).

At Oaktree we believe it may be okay to use leverage to take advantage of unusually generous profit opportunities, but it's dangerous to use leverage to try to wring big returns out of small profit margins.

The most important thing is acknowledging the impact of uncontrollable factors.

Defensive investing, insistence on value, and shying away from leverage -- they're all important. **And much of the reason they're important stems from the fact that so little of short-term performance is under our control.**

Clients say, "We expect you to be in the top quartile after x years." What can we do to satisfy those marching orders?

- We can try hard, but we don't do any more for the client who wants top quartile performance than we do for the one who wants us to be above the median.
- We can put together the best portfolio we can, but doing so will have only limited impact on our relative performance. How we perform in relative terms will depend largely on what our competitors do.
- We can follow all of our guiding principles and execute with skill, but the

performance of the portfolio will be highly dependent on the environment that unfolds.

- We can do everything for the best of reasons, but we can get unlucky (or our competitors can get lucky).

And that's my point. **There are a lot of moving parts in this machine, and many of them are beyond our control.**

We build portfolios based on the intrinsic values we see and the developments we think will unfold. But uncontrollable factors will have a profound impact on the results. It's essential to remember that the fact that something's probable doesn't mean it'll happen, and the fact that something happened doesn't mean it wasn't improbable. **So we educate our clients as to what they can fairly expect, and we count on them to bear in mind the difference between probabilities and outcomes.**

If we see that a manager has reported a good year, it's hard to know whether to attribute it to skill, luck, or the fact that the manager's style was the right one for that moment. Additional years of data can reduce the role of random factors, but numbers can never lead to certainty. Thus the matter of choosing managers can't be entirely quantitative; instead, it has to rely heavily on a meeting of the minds.

The most important thing is telling it like it is.

Given the vagaries involved in the investment process – and they are legion – a thorough understanding based on high quality communications is key in client-manager relationships.

The investment management business employs a lot of people whose job it is to communicate with clients and prospects. I've met a lot of them, and they're articulate, intelligent and personable. Their job is to put their firms' best foot forward. But how?

There's a lengthy continuum – or is it a slippery slope? – from candor, through “spin,” to gilding the lily, and ending in deceit. And in 35 years I've watched people operate at every point along that continuum.

When Oaktree was formed in 1995, we established constructive communications as one of our key business principles. Among the elements we stress are these:

- **Remember that candor and thorough understanding do more to build a strong, long-term relationship than forcing every development into a positive light.**

- Don't take credit for things that go right for the wrong reason.
- Admit when things go wrong – without hiding behind excuses.
- Communicate not just the facts, but also an honest interpretation.

As you know, communicating both inside and outside Oaktree constitutes a major part of my job. It's also the source of a great deal of my satisfaction.

The most important thing is maintaining constructive personnel principles.

Personnel turnover is endemic to the investment management industry and poses an enormous threat to long-term excellence. My career got its start at an institution where large numbers of raw recruits were trained each year, under the assumption that there would always be significant attrition. Because any greatness was expected to emanate more from the institution than from the individuals, however, people were considered fungible and turnover was accepted.

But investing greatness, if it is to be attained, must come from people. Investing is an art, not a science, and few people can master that art. Superior investing is not democratic or egalitarian. If an organization is to be the best, it must find, train and retain the best. Not only does turnover drain off your best people, but it also takes their institutional memory and leaves you bogged down in hiring and training their replacements.

We always have placed great emphasis on preventing turnover, and the results are visible – in the very small number of senior professionals who have moved on to other employment in my 25 years in portfolio management, and in the investment performance that my long-term colleagues have produced. The keys have been (a) hiring team-oriented players who care about something other than just making top dollar, (b) creating a collegial environment in which such quality people will want to work, (c) avoiding stifling bureaucracy, internecine office politics, destructive competition, and overemphasis on short-term results, and (d) always sharing the fruits of our success.

This is one of the few areas where there is a magic formula: be fair. Oaktree's founders always say it's our goal to own less and less of a firm that becomes worth more and more. We think sharing ownership with key colleagues – rather than zealously holding onto it – is key in building a great firm.

The most important thing is acknowledging the difficulty inherent in keeping a partnership intact, and going way out of your way to make it work.

The statistics on divorce suggest that successful long-term unions are far from universal. Certainly in the high-octane investment management world, partnerships form and break up with regularity. But it doesn't have to be that way.

Last month I was privileged to celebrate the twentieth anniversary of my partnership with Sheldon Stone, who joined me as an analyst at Citibank, moved with me to TCW, and has run our high yield bond portfolios since 1985. I found a quote from Andrew Kilpatrick's "Of Permanent Value" with which to mark that occasion, and Shel and I agree it's a pretty good formula for a successful partnership.

I think you'll probably start looking for the person that you can always depend on; the person whose ego does not get in his way; the person who's perfectly willing to let someone else take credit for an idea as long as it works; the person who essentially wouldn't let you down; who thought straight as opposed to brilliantly.

Our success in retaining 100% of our senior partners since 1983, and in maintaining harmony, is something I think about a lot. In doing so, I've identified some of the major impediments to a smooth-running partnership.

First, conflicts of demeanor or style can have a very negative effect on cohesiveness. In the bull market, the aggressive partner says, "That wet blanket's holding us back." In the bear market, the cautious partner says, "That animal's getting us killed." Many of Wall Street's greatest flare-ups have been attributed to "culture clashes," such as the mid-1980s battle between traders and investment bankers that brought Lehman Brothers' independence to an end. I can honestly say that all of Oaktree's leaders subscribe equally to the principles on which our firm operates.

Second, a partnership is problematic if partners don't respect each other's contribution. "I can handle all I do and all of what he does" is a statement with dire portent. In contrast, our interaction at Oaktree is highly symbiotic, and we're fortunate enough to appreciate that fact. I know my partners do a better job of portfolio management than I ever did. And they're glad to have me out visiting our clients, so they can stay back and manage their portfolios.

Last, any partnership can be imperiled by the wrong kind of partner. There are a lot of people in the investment business about whom we might say, "He's a jerk, but he can make you a lot of money." And those people tend to get hired, because the profits they'll make are so tempting. But the only way to avoid rancor, strife and divisive debate is to work with people you respect and like (and vice versa), and who value working together in harmony above making the most money and winning every argument.

So the recipe's simple: shared values and complimentary skills; mutual respect and an appreciation for each other's contribution; and people with whom you enjoy associating.

The most important thing is having something you stand for.

At a recent manager symposium, Roz Hewsenian of Wilshire Associates listed ten things a manager needs in order to survive a period of contracting asset prices and revenues. I've saved one of them for last: **a mission other than Assets Under Management.**

Every day, investment managers are required to:

- negotiate the uncertainties entailed in investing,
- manage their businesses in a changing environment,
- deal constructively with talented, aspiring employees, and
- keep client relationships solid, even though there'll always be unsuccessful investments.

To be able to do all of these things simultaneously, it helps to have a set of guiding principles and a well-thought-out approach. With these you can know how to set your course. You can arrive at decisions that reflect a consistent set of values. And your clients will know what your firm stands for and what to expect from you; **nothing paves the way for a mutually successful relationship better than reasonable and deliverable expectations.**

Here – unlike in personnel policies – there is no magic formula. There are many ways to answer the myriad questions that arise in doing the things a manager has to do. It matters less which answers you arrive at, than that your answers are well thought out, internally consistent, principled, and firmly adhered to. What I've described above are the answers that Oaktree considers “the most important things.”

So that's the list. On reviewing it, I find I've touched on all six tenets of Oaktree's investment philosophy, and most of our business principles as well. We're committed to sticking to these eighteen points through thick and thin. **Doing so takes solid commitment applied with a deft touch – not obstinacy, but insight.** This is especially true in negotiating the conflicts: being clear about your investment intentions but not surrendering investment flexibility; holding fast to your views but stopping short of hubris. And maybe that's the nineteenth point: **never think it'll be easy.**

July 1, 2003

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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

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Memo To: Oaktree Clients
From: Howard Marks
Re: The Feeling's Mutual

Throughout the recent, seemingly endless series of scandals, complaints, settlements, indictments and meltdowns involving corporations, auditors, brokerage firms, investment banks and hedge funds, the mutual fund industry remained untouched. That held true until September 3, when the Attorney General of New York State announced that Edward Stern of hedge fund Canary Capital Partners had paid \$40 million to settle charges relating to improper dealings between Canary and a number of mutual funds. Since then, sordid disclosures involving mutual funds seem to be emerging on a regular basis.

The Canary That Swallowed the Cat

What did Canary do wrong? It admitted to "mutual fund timing" and "late trading." Both of these tactics take advantage of what I would call "temporal disconnects" in the process through which the price for transactions in mutual fund shares is set. A fund's Net Asset Value is supposed to reflect the per-share value of the assets held in the fund's portfolio, so that people buying or selling fund shares at that NAV pay or receive a fair price for their portion of the fund's portfolio. However, the process is non-dynamic, in that the NAV is set just once a day based on the underlying securities' latest closing prices and isn't updated for events that occur subsequent to the market closings or subsequent to the time of the calculation. Canary acted to profit from instances when security prices used to calculate the NAV had become "stale."

Most forms of market timing consist of people undertaking trades in order to implement their views regarding the future direction of security prices. Mutual fund timing is different, however, because the fund timer acts to profit from events that occurred in the past.

The opportunity for mutual fund timing arises from the fact that every fund's Net Asset Value is calculated as of the close of trading at 4:00 p.m. Eastern Time, and orders for fund shares entered up to that time are executed at that price. (Under the rules, orders placed after 4:00 p.m. are executed at the next day's NAV.) In brief, the mutual fund timer acts to take advantage of knowledge that a security price factored into a fund's NAV is out-of-date and not reflective of recent events. For an example, think of a mutual fund that holds a U.K. stock, the trading of which ceased at 4:30 p.m. London time. Since 4:30 p.m. London time is equivalent to 11:30 a.m. in New York, it's the stock's price at 11:30 a.m. Eastern Time that'll be used to calculate the NAV at 4:00 p.m. Thus a timer has 4½ hours in which to watch for a development rendering the London closing price obsolete, be it a general market movement or a company-specific event. In extreme

cases involving infrequently traded securities, a timer may gain an advantage from knowledge that security prices haven't been updated for days or weeks.

At first glance, this all appears relatively benign. It is not improper in itself to trade on knowledge that the prices of some fund holdings are stale. All investors have potentially equal access to this information, and they all have the same ability to enter orders for fund shares up to 4:00 p.m. Eastern Time. Further, most of these situations involve small pricing imperfections that relate to a small portion of the fund's portfolio, and trading on them isn't likely to materially change the return on a long-term investment in the fund.

However, these trades can be highly profitable if the impact is magnified through minimization of the holding period. (E.g., taking advantage of a 1¢ error in a \$10 NAV will add just .1% to the annual return if the fund shares are held for a year, but taking advantage of a new 1¢ disparity every day will increase the annual return by 25%!) Obviously, then, the key to achieving unusual profits through mutual fund timing lies in rapid-fire trading.

The problem is that "knowledge-advantaged short-term trading" is inimical to the interests of a fund's other holders – **in essence, these tactics permit a bystander to occasionally dart into the game and appropriate for himself some profit that otherwise would accrue to the fund's long-term investors** (and also to run up the fund's costs). There are tools the funds can use to discourage short-term trading: they can impose exit fees, turn away investors based on their past behavior, or revoke trades. Many funds have policies of fighting short-term traders, and those policies and the actions the funds will take are set forth in their prospectuses. That's where the problem comes in.

The complaint against Canary Capital states that, "Canary entered into agreements with dozens of mutual fund families allowing it to time many different mutual funds." Some of these funds ignored or contravened the policies stated in their prospectuses, and some accepted compensation for doing so. It is these actions on the part of the funds – and what Canary did to induce them – that are improper.

Late trading is highly analogous to fund timing – it's another form of "knowledge-advantaged short-term trading." However, in this form it consists of placing a buy or sell order for a mutual fund after the 4:00 p.m. deadline, for execution at the previously set NAV, in contravention of the SEC's "forward pricing rule." This is done in order to profit from developments that have occurred since 4:00 p.m. and thus are not reflected in the security prices underlying the NAV set at that time.

Consider the example of a mutual fund that has 4% of its portfolio in a stock that closed today at \$40. An hour after the close, the company announces startlingly good earnings. A "late trader" may conclude that the stock will trade tomorrow at \$50, and thus that, everything else being equal, tomorrow's NAV will be higher by 1% (the 25% stock price increase multiplied by the 4% position in the stock). Thus at 5:30 he enters an order to buy the fund at today's NAV, implicitly buying the company's shares at \$40 and trusting

that the NAV will rise tomorrow. On average, these trades can be highly profitable . . . if the holding period is short enough.

Late trading is less ambiguous than fund timing. It's wrong (and illegal), and no one should be able to do it. It, too, takes away some of the profit that should have gone to the fund's long-term holders. Again, Canary made improper arrangements that allowed it to divert those profits to itself.

Eliot Spitzer compared these two tactics to "betting today on yesterday's horse races." **I seem to recall gamblers calling this "past-posting"; see the classic movie "The Sting" for a tutorial. You'd be surprised how easy it is to win when you bet on races that already have taken place.** All you need is a way to get the bet down. And although making the bet may not be illegal in itself, the things you have to do to get someone to take the bet probably will be.

Canary found mutual fund companies that were willing to permit fund timing and late trading in exchange for capital commitments and fees. **In exchange for benefits for themselves, they were willing to assign some of their investors' profits to Canary.** The relatively open manner in which these arrangements were negotiated, documented and communicated to senior managers (who seem not to have taken exception) suggests to me that the people involved were more stupid (and/or ethically tone-deaf) than they were larcenous. Regardless, however, the schemes went forward, and the NY Attorney General says Canary made "tens of millions of dollars" in this fashion. (Two additional examples have come to light this week. A portfolio manager at Alliance Capital was suspended on suspicion of permitting late trading in his mutual fund in exchange for commitments of capital to his hedge fund, perhaps to increase the incentive fees in which he would share. Also, a former trader at hedge fund Millennium Capital pled guilty to engaging in after-hours mutual fund trading.)

Is This A Big Deal?

The money Canary made from these machinations, while very meaningful to Canary, probably represents a "flesh wound" for the funds' investors. Even "tens of millions" wouldn't materially change the investors' return when spread over a number of billion-dollar mutual funds and a three-year period.

Spitzer's complaint cites an academic study estimating that these tactics divert \$4 billion of profits per year from their rightful owners, the funds' long-term investors. Again, a large absolute sum but not material in relative terms: \$4 billion equates to six one-hundredths of a percent of the \$7 trillion total invested in mutual funds – \$6 per \$10,000. On September 19, the Wall Street Journal cited research estimating that in the fund classes where fund timing might be most profitable, it could reduce investors' annual returns by 1-2%.

So the damage done to an individual shareholder, or all of them put together, isn't enormously material relative to the amount invested, or even the annual return. And by the time the plaintiff's lawyers subtract their fees, the damages won for the aggrieved parties aren't likely to be noticeable.

It remains to be seen whether these tactics were widespread. In any case, I believe they're likely to be less so hereafter. The bottom line for me is that the Canary case, and the existence of fund timing and late trading, doesn't mean the mutual fund game is stacked against the investor. **So does that mean the mutual fund industry is free from major shortcomings? I don't think so.**

The Client Comes First!

Just as in other corners of the money management industry, mutual fund companies face opportunities to make tradeoffs between their own welfare and the welfare of their clients . . . the two of which are far from identical.

There's no question that the interests of clients should come first. Like lawyers, executors and trustees, money managers are fiduciaries. They hold positions of trust and owe a special duty to their clients. **They are not supposed to "split the loaf" between themselves and their clients. Rather, the whole loaf must go to the client, in whose favor all conflicts of interest should be resolved.** This is different from automobile sales, for instance, where it's completely acceptable – and universally understood – that the salesman will try to negotiate a higher sale price for a car in order to generate more revenue for his employer and more commission dollars for himself. Nobody's surprised to hear that car salesmen aren't fiduciaries.

But besides being fiduciaries, mutual fund companies – like other money management firms – are for-profit organizations and marketing machines whose ultimate goal is to collect assets and make money. (There's at least one conspicuous exception: the Vanguard Group – whose Convertible Securities Fund we run – is a not-for-profit company owned by the investors in its funds). Jack Bogle founded the Vanguard Group and is a constant gadfly on the subject of mutual fund company behavior. In an article in the New York Times of September 14, he put it simply:

The Investment Company Act says that the interests of fund shareholders must be placed ahead of all others, but the interests of managers have taken precedence.

Who Protects the Clients' Interests?

In theory, a mutual fund is entirely separate and independent from the company that organizes it. The fund company doesn't "own" the fund or have the "right" to be its adviser. The directors of the fund are supposed to supervise the conduct of the fund,

choose the adviser and revisit their decision annually. **I would characterize this arrangement as largely a legal fiction.**

The website of the Investment Company Institute, an industry lobbying group, states the following:

The directors or trustees of a mutual fund, as in the case of other types of companies, have oversight responsibility for the management of the fund's business affairs. . . . Under state law, directors . . . are expected to exercise sound business judgment, establish procedures and perform oversight and review functions, including evaluating the performance of the investment adviser . . . Directors also owe a duty of undivided loyalty to the fund.

Overlaying state law duties is the fundamental concept of the 1940 Act that independent fund directors serve as watchdogs for the shareholders' interests and provide a check on the adviser and other persons closely affiliated with the fund.

In my opinion, a number of significant issues surround mutual fund directors:

- **First and foremost, I am highly skeptical of their collective performance, given that it is unheard of for a fund company to be terminated as the investment adviser of one of its funds.** Have you ever heard of fund company XYZ being relieved of its duties as adviser of the XYZ Fund? From the fact that it never happens, we're supposed to believe that **in every case** the independent directors review the award of the management contract and conclude that XYZ continues to be the best possible manager for the fund. Can we possibly believe this process takes place? And that the fund company **never** deserves to be replaced?
- It seems unlikely that some of the directors in big fund families can know enough about all of their funds to make informed decisions. For example, the New York Times mentioned that the chairman of one fund board monitors 191 funds, and that a director oversees 60. How much can these directors know about the operation of each fund?
- There is good reason to question the independence of some of the funds' "independent directors." A good number of them are former employees of the fund companies. How likely are they to take away an advisory contract from their former firms? And how likely is an independent director to remain a director after he votes to fire XYZ as the manager of the XYZ Fund?
- Lastly, as in the case of corporations, there's the paradox of director compensation. Being a good director involves a lot of work, and it probably won't be done without a lot of compensation. But if the compensation is high enough, directors will want the job too badly to allow them to rock the boat. The board chairman referred to above was paid \$816,000 last year. How likely is he to vote to fire the management company?

The September 14 Times article included the following statements from observers of the mutual fund industry:

Mutual fund directors sit on too many boards, and they are paid too much money for the time they devote to each individual portfolio. Under existing law the investment adviser is able to exercise a pervasive influence over the board. (Lewis D. Lowenfels, a securities lawyer at Tolins & Lowenfels)

Directors certainly aren't doing much. We don't see much in the way of fee reductions – we see fee increases. When funds do terribly badly we don't see any management changes. We see directors' pay going up every year, and we see some pay that is just beyond the rule of reason, often paid to former executives of the management company. Fund boards only meet four times a year on average and they are still dominated heavily and intellectually by affiliated directors. (John C. Bogle)

There were also a number of quotes from fund management company spokesmen:

The Putnam trustees have a long record of independence. They were the first to have an independent nominating committee and the first to have an independent chairman. (John A. Hill, Chairman of Putnam's board)

The Fidelity board always is conscientious and diligent in the service of the fund shareholders. We are proud to have on our board individuals who have the highest standards of integrity and business ethics. (Vincent Loporchio, Fidelity spokesman)

Our fund directors are without exception distinguished leaders from business and government whose experience and insight serve our fund shareholders well. (Phillip J. Purcell, Morgan Stanley CEO and fund director)

These protestations of diligence and independence would mean a lot more to me if the directors of these funds had a history of occasionally terminating the fund company as investment adviser.

Issues Regarding Marketing

Ever since I was a teenager, I've heard that "mutual funds aren't bought; they're sold." In this regard they're like many other consumer goods. People don't decide they need them and figure out which one is the best. Often, rather, people are convinced to buy mutual funds through salesmanship.

Mutual fund families are money-raising machines. They include some of the best marketing companies in America. But some of their excellence serves to enhance their treasuries at the possible expense of their clients.

- Of course, the industry stands for the delivery of active investment management to the masses (although some firms also provide passive management through index funds). Sales are achieved on the basis of comparisons against other mutual funds. **Little is said about the long-run ability (or inability) of funds to beat the market.**
- Some mutual fund families offer so many funds, of such an amazing variety, that it's not illogical to wonder whether their motivations don't include a desire to always have **something** in the top quartile, and something to advertise with four stars.
- The funds in the bottom quartile, on the other hand, have a striking tendency to be merged out of existence – causing their performance records to disappear.
- The industry can be criticized for hyping (and selling) funds in whatever market sector is "hot." Certainly we don't see any warning labels to the effect that "hotness" can be synonymous with elevated prices, and thus with the potential for subsequent losses. The mutual funds that were on magazine covers during the tech bubble buried their clients. **It's not a coincidence that the average fund investor does worse than the average fund;** it's because investor money is constantly being lured into the funds that have been performing best, and thus are the most precarious.
- Lastly, compensation arrangements at mutual fund sales organizations can be adverse to the clients' best interests. For example, there may be incentives to steer capital to a brokerage house's in-house-managed funds as opposed to selling competing funds – because a dollar invested in an in-house fund brings the firm more profit. Once I described a fund to a marketer in terms of its current yield, yield to maturity and yield to call. He said, "Forget about that; let's talk about the thing that matters most: YTB" . . . meaning "yield to broker." There was no doubt where his motivation came from.

Issues Regarding Expenses

Most mutual funds operate in "efficient markets," where it's hard for one portfolio manager to get an edge versus the others. It's rare in the long run for any fund to beat its market benchmark or the other funds of similar riskiness in its niche. In efficient markets, expense minimization is the surest route to better net results, and it's for this reason that Jack Bogle pioneered the creation of index mutual funds. The performance of an index fund is certain to mirror that of the market, and expenses truly are minimized.

But almost all mutual funds are actively managed, and their expenses are anything but minimized.

- The average mutual fund carries investment management fees far above those paid by institutional investors, even those investing far smaller amounts of money.

- The administrative expenses borne by the funds are high and, most significantly, have not demonstrated a tendency to decline in percentage terms as the size of funds has increased. That is, they haven't reflected any economies of scale.
- Many fund shareholders pay continuing marketing charges. Why should the costs of selling funds be borne by the shareholders? The usual response is that a bigger fund benefits its shareholders. But then, shouldn't increasing size result in a declining expense ratio?
- Even as the total assets of the top 25 equity funds were increasing 845 times over the last 51 years, the average expense ratio rose from .64% of assets to 1.50%, **an increase of 134%**. (Source: "The Mutual Fund Industry in 2003: Back to the Future," by John C. Bogle)

As the total assets of the top 25 equity funds grew from \$2.2 billion in 1951 to \$1.9 trillion in 2002, the charges for managing and administering a dollar of assets more than doubled. One wonders how many of the "diligent, independent" directors resisted those increases.

* * *

Are mutual funds good for America? In delivering market participation to retail investors and capital to America's companies, they're invaluable. In hyping hot investments and charging high fees for modest performance, they provide no great service.

Are mutual funds safe vehicles for investing? They're no safer than the markets in which they invest, or passive funds. But cost aside, they're not much worse.

Are mutual funds scandal-ridden? The Canary Capital incident doesn't worry me, but I think the long-term structural issues discussed above are very troubling.

Mutual funds are a good thing overall, and they could be made even better. But that will require a conscious decision to always place the interests of fund shareholders above those of the fund companies. In many cases, that's going to take a while.

October 2, 2003

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Memo to: Oaktree Clients

From: Howard Marks

Re: Hey, Steward!!

Webster's defines a "steward" as a household manager, union representative, fiscal agent or one who attends passengers while traveling. Some of these concepts have become less relevant in today's world.

- Before World War II, ocean voyage was the main mode of transportation abroad, and the steward was someone passengers depended on for their welfare.
- When plane travel took over from ships, it was the stewardess (and then in the 1980s, the steward again) who played the same essential role. Of course, in the 1990s, political correctness caused "stewardess" and "steward" to disappear in favor of "flight attendant."
- The trade union movement has depended heavily on the work of the shop steward, the union representative closest to the men and women of the rank-and-file.
- And when I started in the investment management business in the 1960s, those who managed money for others thought of themselves – and were thought of – as stewards of their clients' money. They aimed to protect their clients from loss and generate a reasonable – even an attractive – return as long as it could be done with risk in check.

With the passage of time, I find I hear the word "steward" less and less. But in talking about the mutual fund irregularities that have been exposed in the last few months, I cannot help but borrow a phrase from Jack Bogle that employs it. (I wish I could coin the phrases I use in these memos, but usually I find myself relying on the creativity of others. In this case, I absolutely can't improve on Jack's way of putting it.) On November 8, The Economist quoted him as saying, "Amassing assets under management became the [mutual fund] industry's primary goal, and **our focus shifted from stewardship to salesmanship.**" (Emphasis added)

That's it. Right there. In a nutshell. Of course some of the late-trading incidents involve individuals who simply took money out of their clients' pockets and put it in their own (metaphorically). **But in case after case – involving late trading and other issues – mutual funds companies forgot their duty as stewards of other people's assets, doing things that disadvantaged clients in order to build assets under management for their own benefit.**

Each of us faces the need to balance our own interests against those of others. The salesman stresses the positives and soft-pedals the negatives to increase his

commissions. The head of a charity draws a salary that reduces the amount left for the organization's good work. The doctor collects for his services, and the more he charges, the fewer the people who can afford them. And we investment managers charge management fees, and sometimes a percentage of the profits, that cut into our clients' net return. We all want to increase our incomes, but it should be possible to stick to the high road while doing so. The tradeoffs present challenges, but they can be overcome.

I do not argue that mutual fund executives – or investment managers in general – should be expected to serve in an eleemosynary capacity. Certainly Oaktree doesn't run on pure altruism. Vanguard comes close to the ideal, as a non-profit organization owned by its fund owners, but Vanguard's people take compensation, not vows of poverty. **The critical question in my mind isn't whether people make money, or even how much, but what methods they employ to do so, how candid they are about those methods, and how the inevitable conflicts of interest are resolved.**

What's Wrong With a Little Salesmanship?

My October memo "The Feeling's Mutual" argued that late trading wasn't the worst thing going on in the mutual fund industry. Rather, it pointed to questionable long-term practices relating to governance, marketing and compensation.

[Before I go further, I want to do something I failed to do in October: make clear that neither my earlier memo nor this one is intended as a universal indictment of the mutual fund industry. While there are questionable aspects to the industry's general practices and some bad apples, there also are clean operators and even shining examples. I apologize to any of the latter that feel I've treated them like the former. The good news is that the money withdrawn from the bad apples is being reinvested in other mutual funds, meaning the good citizens are being rewarded, as they should be.]

Recent months have brought disclosure of a variety of questionable asset-building practices.

- Revenue sharing – According to the Wall Street Journal of January 9, this is an arrangement through which, in addition to any explicit sales compensation, "fund companies give brokers a cut of their management fees to induce them to sell their products." Many brokerage firms have a list of preferred funds or fund companies, and often the funds pay to be on the list. The Journal reported, for example, that Edward D. Jones & Co. "has selling arrangements with about 100 mutual funds, but 90% to 95% of its fund sales come from the seven preferred companies who engage in revenue sharing." Under revenue sharing, a brokerage firm can get a percentage of the assets invested in the relevant funds or of the management fees (and in some cases, of both).
- Brokerage-for-sales deals – These were described by the Journal (January 13) as

“arrangements under which fund firms direct trades to . . . brokerages in returns for its (sic) funds staying on their ‘preferred list.’” Sometimes funds allocate commissions to brokerage firms in order to pay off the revenue sharing obligations described above.

- Sales incentives – In its article on Jones, the Journal also reported “more than half of the firm’s brokers are invited on [Caribbean cruises and African-wildlife tours paid for by fund companies on the preferred list], based on meeting certain overall sales targets.” At some brokerage firms, brokers have received higher commission rates for selling funds that generate revenue sharing. Elsewhere, the commissions for selling funds managed by the brokerage’s in-house money management arm have been higher than those on third-party-managed funds.

On January 13 the Securities and Exchange Commission said that 14 out of 15 broker-dealers it examined had received cash payments from mutual fund companies. Is it wrong for brokerage firms and/or their brokers to receive compensation for emphasizing a company’s funds? After all, supermarkets accept compensation from food companies for giving them more desirable “shelf space.” Isn’t that a valid analogy?

The answer lies in the significant distinction between an ordinary businessman and a trusted adviser. Supermarkets have no fiduciary duty to their customers, and customers don’t expect supermarkets to provide objective, professional advice regarding which brands to buy. The opposite is true for stockbrokers.

Under securities laws, brokers are held to the high standard of trusted financial advisors – not just salespeople – and must either offer objective advice or properly disclose any serious conflicts. . . . “We recognize there is a conflict of interests between the broker and the mutual fund investor,” says Robert Plaze, associate director of the SEC’s Division of Investment Management. “That client needs to understand the recommendation of their broker is being affected by these payments.” (Wall Street Journal, January 9)

How would you like to learn that the heart surgeon to whom your general practitioner sent you had paid for the referral? That your banker recommended a trust-and-estate lawyer in exchange for a holiday cruise? Or that the broker who suggested you buy a certain fund was paid to do so?

“The deception is that the broker seems to give objective advice,” says Tamar Frankel, a law professor at Boston University who specializes in mutual-fund regulation. “In fact, he is paid more for pushing only certain funds.” (Ibid.)

The Los Angeles Times put it another way on January 18:

There are two ways to describe such payments, and both smell bad, said Don Phillips, a principal at fund research firm Morningstar, Inc. in Chicago: They’re either bribes by mutual fund companies to spur sales, or they’re blackmail by the

brokerages to do the same.

In the case of mutual funds that direct brokerage commissions to reward fund sales, there's an additional alarming element: **Not only is the fund company paying for a recommendation, but it's making these payments with its client's money, not its own.** Commissions belong to the client. They should go to pay for things that benefit the client, such as superior research or best execution. When they are used to reward fund sales, their use benefits only the fund company.

Sunlight as Disinfectant

The solution is to inform clients of these practices. Where the interests of client and broker are in conflict, the broker should disclose the conflict. In this case, he should tell clients that he and his firm received special compensation for making the recommendation they've made, or for having sold large amounts of certain funds. Fund companies and brokers would respond that they've done just that.

The problem is that the SEC agreed that disclosure needn't be made directly by each broker to each client. Instead, general disclosure in mutual fund prospectuses is enough. **Unfortunately, "legal disclosure" too often seems to be an oxymoron,** guided primarily by the question "how can we say something so as to minimize the likelihood that the reader will understand what we said?" For example, according to the Journal of January 9, ". . . Putnam typically discloses in its prospectuses that it may 'pay concessions to dealers that satisfy certain criteria established from time to time by Putnam Retail Management relating to increasing net sales of shares of Putnam funds over prior periods, and certain other factors.'" Huh?

How many prospectus readers are capable of extracting the significance from that sentence? How many know the meaning of the word "concession" in this context? How many even read the last dozen "boilerplate" pages of a prospectus?

First, I think regulators should insist not on disclosure, but on **effective disclosure.** Things should be expressed in everyday English, such that laymen can grasp their significance. And the things that matter should be separated from the things that don't.

Second, disclosure of the conflicts between fiduciary and client should be made directly by the fiduciary, and should be made clearly. How about, "The fund's sponsor is paying me extra to recommend this fund to you"?

The Average Common Denominator

As I wrote in "The Feeling's Mutual," I think the most significant failing of the mutual fund industry – and the area where the most sweeping changes hopefully will be seen – relates to the governance responsibilities of fund directors. This can be looked at, for

example, in terms of the management fees paid by mutual funds.

I believe most of the mutual funds in a given market sector pay management fees (setting aside administrative expenses and marketing charges) significantly above those paid by institutional accounts of comparable size. While the cash inflows and outflows experienced by mutual funds may cause higher turnover – and thus more work for portfolio managers and back office personnel – the successful funds also see asset growth. So I see no justification for higher fee rates.

It's the job of fund directors to police fees and ensure that they're justified and fair. Do they do this? Do they actively resist requests for increases or pursue reductions? Who goes to the mat on behalf of the fund holders to keep down the management fees? With fund boards often headed by current or retired management company executives, how vigorous are the efforts to minimize fees?

Here's what I think is a typical response, from John Hill, independent board chairman for the more than 100 mutual funds operated by Putnam: "We spend a lot of time looking . . . at costs. **We've had a rule for years that fund expenses can't be any higher than the median expenses of comparable funds across the industry.**" (WSJ, January 13, emphasis added.)

In other words, **the directors aren't concerned about whether fees are fair or justified. Or whether they're comparable to institutional account fees. They just look at how their funds' fees stack up against those of other funds.** So if the average mutual fund in a given sector pays its management companies a fee well above the institutional rate, they're willing to do so also.

Suppose you wanted to invest \$1 million of your own in high yield bonds. If you learned that a high yield mutual fund charges a .65% management fee while institutional managers charge .50%, you'd probably choose the latter. The knowledge that every high yield mutual fund charges .65% likely wouldn't alter your decision. But mutual fund directors seem to derive great comfort from it.

Last week I conducted an empirical study by accessing the websites of the first nine high yield mutual funds that came to mind. The management fees on seven of these multi-billion dollar funds exceeded the institutional norm of .50%, ranging from .58% to .75% and averaging .65%. I wonder what those funds' managers charge institutional accounts of similar size.

I've often heard the rejoinder that the "little guy" with \$50,000 to invest can't get into a top institutional manager. And even if he could, he couldn't access the lowest fees. Thus it's reasonable that he pays fees above institutional rates – he can't do any better. But the fund could. **Why shouldn't the aggregation of 1,000 little guys, each with \$50,000, pay the same fee as an institution investing \$50 million?**

In this year's Berkshire Hathaway annual report, Warren Buffett shares his observations

regarding mutual funds. “Year after year, at literally thousands of funds, . . . the directors had mindlessly approved fees that in many cases far exceeded those that could have been negotiated.” In response, he proposes independent fund directors affirm each year that “we have negotiated a fee with our managers comparable to what other clients with equivalent funds would negotiate.” We’ll see if they do.

Are fund directors and executives putting their clients’ interests first? Are they acting as the stewards of their clients’ assets? Is there room for improvement? I feel there’ll be a lot of scrutiny on this subject in the months ahead. Hopefully all mutual funds and their directors will end up acting a lot more like stewards.

The New Math: $4 + (12b-1) = 3$

Back in 1980, some genius figured out a way for the mutual fund companies to extract more from their funds: use investors’ assets to pay the costs of fund distribution. Rule 12b-1 was adopted, permitting charges against fund assets for this purpose. According to a Morningstar report of January 6, “The rule was introduced following a period of substantial outflows for the fund industry and was intended to help funds grow their assets.”

It was felt that asset growth would benefit funds and their investors, and thus it would be proper for investors to bear some of the cost. According to the rule:

A [mutual fund] company may implement or continue a [12b-1] plan . . . only if the directors who vote to approve such implementation or continuation conclude, in the exercise of reasonable business judgment and in light of their fiduciary duties . . . that there is a reasonable likelihood that the plan will benefit the company [i.e., the fund] and its shareholders.

As Morningstar puts it, “the latter phrase would seem to require that the fee will result in more assets, and ultimately lower costs – otherwise, there is no benefit to the fund” (or its investors). **Of course, fund companies would have a clear conflict: more expense reimbursement for them would translate directly into lower asset values for their investors.** The SEC recognized this conflict and stated in the release accompanying the rule that it remained “generally concerned about (1) the conflicts which may exist between the interests of a fund and those of its investment adviser in deciding whether a fund should pay its distribution costs, (2) the likelihood that the fund will benefit from paying such costs, and (3) fairness to existing shareholders.”

Thus the SEC required that 12b-1 fees be approved by majorities of the full board, the disinterested (i.e., independent) directors, and the fund’s shares. It went on to state that, “Since rule 12b-1 does not restrict the kinds or amounts of payments which could be made, **the role of the disinterested directors in approving such expenditures is crucial.**” (Emphasis added)

Based on data contained in Morningstar's excellent report, the results in this regard are not encouraging:

- Of the 15,774 funds tracked by Morningstar, 9,981, or 63%, charge 12b-1 fees.
- Of 4,556 12b-1 funds for which there is at least five years of data on expense ratios, 66.2% showed an increase in the expense ratio over the last five years.
- The percentage of funds showing expense ratio increases was roughly the same in 12b-1 funds as in non-12b-1 funds, but the average increase for the 12b-1 funds was slightly greater than for the non-12b-1 funds.
- When looked at for nine years, the comparison is more negative. 12b-1 funds showed expense ratio increases more often than non-12b-1 funds, and the differential between the increases in the two groups was more unfavorable.

As Morningstar puts it, "The above data strongly suggest that 12b-1 fees do not help funds materially reduce their expense ratios over time any more than would otherwise be the case, and may, in fact, do the opposite."

The fund companies have successfully transferred some of the costs of distribution to the funds' investors, using 12b-1 fees primarily to pay brokers in order to increase assets and benefit the fund companies. But there is no evidence – certainly not in the form of decreasing expense ratios – that they benefit investors, as they're supposed to. Despite this, Morningstar says, "Even as funds grow, their 12b-1 fees don't usually decrease or go away."

Why are 12b-1 fees so widespread and so persistent? And what's the reasoning of the independent directors who approve them? How do the directors feel about the buy-and-hold investor who invests in fund shares and pays distribution fees for the next twenty years? At best, I'm afraid, the director's answer regarding 12b-1 fees can only be the same as it is on management fees: "Our practices are no worse than those of our competitors."

One gem on which to close: currently, 12b-1 fees are being collected by 227 mutual funds (or classes of multiple-share-class funds) that are closed. How can the directors of funds that aren't trying to attract new investors justify the continuing imposition of fund distribution charges? How can they possibly interpret this as fulfilling their responsibilities to the funds' investors? Who do these directors represent?

What Else?

I want to make it clear that just as I do not universally indict mutual fund executives and directors, I don't think stewardship problems exist only in the mutual fund industry. Most of the shortcomings disclosed in the corporate scandals of 2001-02 – in Enron, WorldCom, Adelphia, HealthSouth and Tyco – stemmed from the failure of executives to act on behalf of the shareholders who own the companies, and from the

failure of directors to police the executives.

The examples are endless: excessive compensation, unwarranted expenditures, phony accounting, and transactions intended only to deceive or obfuscate. In general, executives forgot that they run companies for their owners and instead tried to turn them into personal piggybanks. Or they decided to eschew honest reporting in order to hype results and thus their own economics. Directors of these companies haven't been accused of wrongdoing, just underachieving. They were too complacent and obliging, and thus asleep at the switch. As Warren Buffett says, "sadly 'boardroom atmosphere' almost invariably sedates their fiduciary genes."

The fundamental questions regarding corporate directors and executives are the same as those I proposed earlier regarding mutual funds: How much ends up in the pockets of the company and its owners, and how much in the pockets of the stewards? What means are used to accomplish this "wealth transfer"? How much is disclosed, and how clearly?

A number of thought-provoking examples were discussed in the Wall Street Journal of December 29, under the headline "Many Companies Report Transactions With Top Officers; 'Related Party' Deals Disclosed By 300 Large Corporations; Potential for Conflict." The article discussed not the headline-grabbing misdeeds of the scandal era, but matters that are routine at America's largest corporations. Often called "related-party transactions," they represent deals through which directors or executives receive benefits beyond their standard compensation. Of course, there's only one possible source for this enrichment: the companies and their shareholders. The Journal and I draw no conclusion about whether these things are proper. But they certainly can serve as fodder for discussing the performance of stewards. Here are a few examples:

- A company employs or has business ties with 17 relatives of senior officials.
- An executive is reimbursed for making business trips on his airplane.
- A company buys "financial advisory services" from a director's company.
- Directors receive hundreds of thousands of dollars in consulting fees, above and beyond their directors' fees. The fees reward the director/consultants for supplying "general information" or "maintaining and enhancing the company's strategic alignment." In the latter case, the recipient happens to be the company's second-biggest shareholder.
- A lawyer serves on a corporate board, and the company gives legal work to his firm.
- The son-in-law of a former board chairman runs a real estate joint venture involving the company, to which the company guarantees a minimum level of profitability.
- A company sells an amusement park to its controlling shareholder, with the buyer paying half the purchase price in the form of passes to the amusement park he just bought.

The Journal put it succinctly. "All these deals present the risk of conflicts between a company official's two roles: representative of the shareholder and individual seeking to get the best deal for himself." They raise significant questions:

- Are these deals negotiated at arm's length? Are the terms the best the company can get?
- Who negotiates on behalf of the shareholders? How vehemently?
- Where a deal is proposed by a shareholder or shareholder/director with a dominant ownership position, who stands up for the minority shareholders?
- How can we be sure director A won't simply vote for director B's excessive deal in exchange for director B returning the favor?
- As I mentioned above, there has been no allegation – even in Enron, Tyco and Adelphia – of actual director impropriety. Rather, the questions surround the energy put into governance.
- After working together for many years, directors develop congenial relationships with each other and with the executives. How strongly will they then fight to resist questionable transactions between the company and their colleagues?
- Directors' fees can run into the hundreds of thousands, perhaps with stock options and perks in addition. Will a director risk this package to fight for some faceless shareholders?
- In short, can a director who serves at the pleasure of the chairman police the chairman and his other handpicked directors and executives? How can directors be guaranteed the independence that shareholders need them to have?

The industrial economy achieved great strides because of a number of advances, one of which was the separation of management from ownership (and the accompanying development of a class of professional managers). **The caveat, of course, is that managers and directors must serve diligently as stewards, protecting the interests of the firm's absentee owners. The system only works if the stewards – entrusted with responsibility on behalf of others – are up to the task.**

The Bottom Line

As you prepare your estate plan, you count on fiduciaries – lawyers, accountants, executors and trustees – to ensure that your assets will be disposed of as you intend. Would you want one of those fiduciaries to buy assets directly from your estate? Rent office space to your estate? Employ his relatives to serve your estate, for additional fees? Enter into a joint venture with the company you left behind? You'd expect the stewards of your estate to be "purer than Caesar's wife." **Even with motivations that are entirely honorable, it would be impossible for your fiduciaries to simultaneously represent themselves and your heirs on opposite sides of a transaction and still maintain both the fact and the appearance of fairness.** Thus they must content themselves with the compensation they've been assigned by you or by law. They must resist the temptation to do business with your estate in a way that could benefit them further . . . and to possibly move a little from your heirs' pockets to their own. We must expect no less from the stewards that we and our companies do business with every day.

In my memos I try to resist citing Oaktree as the paragon of virtue. But when we founded our company, we established an acid test that we routinely rely on to keep us

on the right track. It was stated in our original brochure in 1995, and it has served us well ever since.

It is our fundamental operating principle that if all of our practices were to become known, there must be no one with grounds for complaint.

To put it more simply, we assume everything we do will show up on “page one” some day – that nothing will remain a secret. Will there be a negative reaction? Will anyone object? It’s a simple test, but it seems every day that the newspapers describe someone whose actions could only have been premised on the assumption that no one – not media, shareholders, clients, auditors or regulators – would learn the truth.

Will directors approve of executives’ actions? Will shareholders feel that directors did their job correctly? Will clients conclude that fiduciaries have put responsibility to them ahead of their own interests? We think the standards for stewards’ behavior are pretty clear cut, which means making these assessments shouldn’t be that hard.

March 16, 2004

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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 Taleb. 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

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Memo to: Oaktree Clients
From: Howard Marks
Re: The Happy Medium

My second general memo to clients was dated April 11, 1991 and imaginatively titled “First Quarter Performance.” It primarily discussed the swing of the market pendulum. I may be biased, but I’m pleased with what it says and, thirteen years later, wouldn’t change a word.

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.”** (Emphasis added)

Although I’ve learned a great deal in the time since that memo was published, I still think the paragraphs excerpted above capture almost the entire essence of market movements.

I continue to believe that cycles are inevitable, often profound, and the most reliable feature of the business and investment worlds. In November 2001 I wrote a memo on this subject entitled “You Can’t Predict. You Can Prepare.” (It didn’t generate any reader reaction, even though I thought its contents were important.) The memo discussed some of the cycles that affect the investor:

- The **economic cycle** evidences **moderate fluctuations** (although their impact can be profound). Viewed on a long-term graph, it looks like a gentle wave.
- The **business cycle** responds to developments in the economy with a **more pronounced effect**, rising and falling as consumers and businesses loosen and tighten their purse strings.
- The **profits cycle** reflects an **exaggerated reaction** to changes in the amount of business companies are doing, primarily because of the twin influences of operating leverage (such that

operating profits change more than revenues) and financial leverage (such that net income changes more than operating profits).

- The **credit cycle** moves **dramatically**, usually oscillating between periods when the capital markets are wide open and periods when they're slammed shut.
- The **market cycle** reacts **violently**, as investor psychology magnifies all of the above. Security prices yo-yo in what can often be described as extreme over-reaction.

Everyone's aware of these cycles and their influence on the markets, but it's important that their essence and origin be thoroughly understood. For me that means delving into human nature and emotion. The theme of this memo will be that **the cyclical phenomena that so heavily influence our investment outcomes aren't caused by the operation of institutions or physical laws. Rather, they largely result from people's frailties and excesses.** A thorough understanding of these things can increase an investor's ability to achieve gains and avoid losses.

Greed or Fear

When I was a rookie analyst, we heard all the time that "the stock market is driven by greed and fear." When the market environment is in healthy balance, a tug-of-war takes place between optimists intent on making money and pessimists seeking to avoid losses. The former want to buy stocks, even if they have to pay a price a bit above yesterday's close, and the latter want to sell them, even if it's on a downtick.

When the market doesn't go anyplace, it's because the sentiment behind this tug-of-war is evenly divided, and the people – or feelings – on the two ends of the rope carry roughly equal weight. The optimists may prevail for a while, but as securities are bid up they become more highly priced, and then the pessimists gain sway and sell them down. The result is a market that rises or falls moderately if at all – not unlike the experience so far this year. For example, as The Wall Street Journal wrote on May 17,

The Dow Jones Industrial Average has been down for three weeks in a row, . . . Still, a determined group of optimists has refused to throw in the towel, stepping in to buy what they view as cheap stocks whenever prices began to plummet. On Wednesday, when the Dow Industrials fell as low as 9852.19 during the day, these people began to buy, pushing the blue-chip average back above 10000.

Two forces continue to compete in the market: those who believe that the current skittishness will end once investors get used to the idea of rising interest rates, and those who think further stock declines are inevitable.

It didn't take long in my early days, however, for me to realize that often the market is driven by **greed or fear**. At the times that really count, large numbers of people leave one end of the rope for the other. Either the greedy or the fearful predominate, and they move the market dramatically. **When there's only greed and no fear, for example, everyone wants to buy, no one wants to sell, and few people can think of reasons why prices shouldn't rise.** And so they do – often in leaps and bounds and with no apparent governor.

Clearly that's what happened to tech stocks in 1999. Greed was the dominant characteristic of that market. Those who weren't participating were forced to watch everyone else get rich. "Prudent investors" were rewarded with a feeling of stupidity. The buyers moving that market felt no fear. "There's a new paradigm," was the battle cry, "get on board before you miss the boat. And by the way, the price I'm buying at can't be excessive, because the market's always efficient." Everyone perceived a virtuous cycle in favor of tech stocks to which there could be no end.

But eventually, something changes. Either a stumbling block materializes, or a prominent company reports a problem, or an exogenous factor intrudes. Prices can even fall under their own weight or based on a downturn in psychology with no obvious cause. Certainly no one I know can say exactly what it was that burst the tech stock bubble in 2000. But somehow the greed evaporated and fear took over. "Buy before you miss out" was replaced by "Sell before it goes to zero."

And thus fear comes into the ascendancy. People don't worry about missing opportunities; they worry about losing money. Irrational exuberance is replaced by excessive caution. Whereas in 1999 pie-in-the-sky forecasts for a decade out were embraced warmly, in 2002 investors chastened by the corporate scandals said, "I'll never trust management again" and "How can I be sure any financial statements are accurate?" Thus almost no one wanted to buy the bonds of the scandal-plagued companies, for example, and they sunk to giveaway prices. **It's from the extremes of the cycle of fear and greed that arise the greatest investment profits, as distressed debt demonstrated last year.**

Risk Tolerance or Risk Aversion

In my opinion, the greed/fear cycle is caused by changing attitudes toward risk. **When greed is prevalent, it means investors feel a high level of comfort with risk and the idea of bearing it in the interest of profit. Conversely, widespread fear indicates a high level of aversion to risk.** The academics consider investors' attitude toward risk a constant, but certainly it fluctuates greatly.

Finance theory is heavily dependent on the assumption that investors are risk-averse. That is, they "disprefer" risk and must be induced – bribed – to bear it. That's the reason why the capital market line slopes upward to the right: investors have to be offered higher expected returns in order to induce them to make investments entailing higher risk. Of course, these higher returns can't be a sure thing, because in that case the investments wouldn't actually be riskier. So the higher expected returns have to be accompanied by greater uncertainty (a broader dispersion of possible outcomes) or higher actual risk of losing money.

But there are times when investors ignore the uncertainty and risk of loss associated with higher possible returns and pursue them too avidly. In 1996, I asked a consultant why his firm was one of the few that didn't recommend Oaktree's high yield bond management. His answer was simple: "We're trying to maximize risk, and we can't do that with you." Of course, that answer was shorthand for something that made a little more sense: that in theory the way to increase return is to bear more risk, and he thought Oaktree's

portfolios didn't contain enough risk to be top performers. **In other words, he was saying, "risk is our friend."**

It just can't work that way! **Dependably high returns from risky investments are an oxymoron. But there are times when this caveat is ignored; when people get too comfortable with risk; and thus when securities prices incorporate a premium for bearing risk that is inadequate to compensate for the risk that's present.**

The prevalence of risk-tolerance (or risk-obliviousness) in the late 1990s was clear. I personally heard a prominent brokerage house strategist say, "Stocks are overpriced, but not enough to keep them from being a buy." And we all heard the man on the street say "I'm up so much in my 401(k), it wouldn't bother me if it fell by a third." (Where was that guy two or three years later?)

No, those risk-tolerant attitudes will not persist forever. Eventually, something will intrude, exposing securities' imperfections and too-high prices. Prices will decline. Investors will like them less at \$60 than they did at \$100. Fear of losing the remaining \$60 will overtake the urge to make back the lost \$40. Risk aversion eventually will reassert itself (and usually go to excess).

How about some quantification of this cycle? In mid-1998, just before the collapse of Long-Term Capital Management brought investors other than techies to their senses, only **\$12.5 billion** of non-defaulted bonds yielded more than 20% (one possible threshold for the label "distressed debt"). Because investors weren't very worried about risk, they demanded ultra-high returns from relatively few non-defaulted bonds; the word "blithe" might best describe their attitude.

But Long-Term's demise awakened investors to the existence of risk, and a year later, the amount of bonds yielding more than 20% had more than tripled to **\$38.7 billion**. By mid-2002, when the corporate scandals held the debt market in a grip of terror, the 20% yielders had grown to **\$105.6 billion**, eight and a half times the level just four years earlier. Risk aversion had come a long way from inadequate and, as later events showed, had become excessive. By March 31, 2004, this figure had fallen 85%, to just **\$16.2 billion**; risk aversion had subsided (and possibly had become inadequate again). I'm sure that fundamentals didn't fluctuate anywhere near the degree reflected in prices, yields and thus the distressed debt tally. As usual, reality was greatly exaggerated by swings in psychology.

When investors in general are too risk-tolerant, security prices can embody more risk than they do return. When investors are too risk-averse, prices can offer more return than risk. For me, Warren Buffett's quote best sums up this phenomenon and the contrarian position that is required as a result: **"The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."**

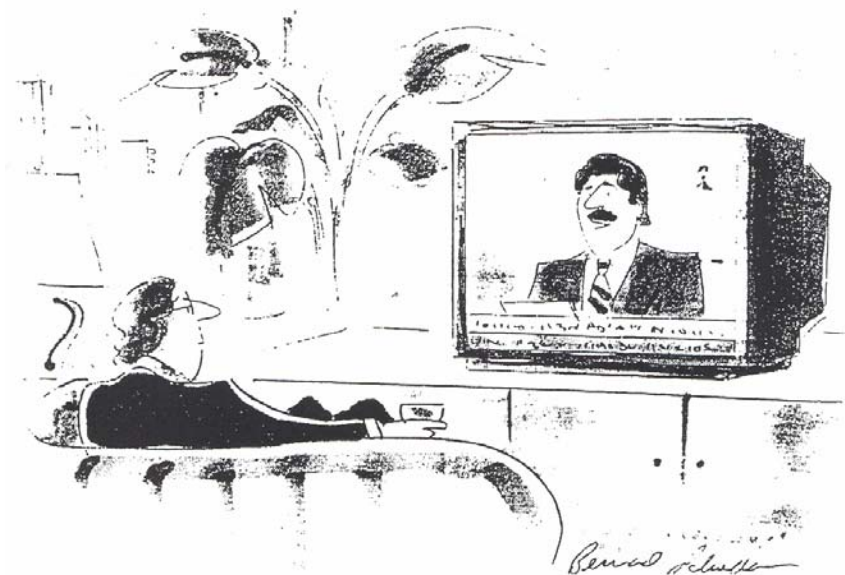
Full or Empty

One of the most volatile cycles relates to the willingness of investors to interpret events positively or negatively. Forget the traditional half measures; investors see their glass completely full at some times and totally empty at others.

It isn't nonsensical for assets to be viewed differently at different times. After all, almost everything incorporates elements of both good and bad. But there are times when investors seem to look only at the positives or only at the negatives. **As a result, there are times when there seems to be no price so high that investors won't pay it, and these inevitably are followed by times when no price is low enough to convince people to buy.**

This oscillation – from viewing a security, a company or an investment technique as “flawless” to viewing it as “worthless” – has occurred several times during my time in the investment business, with the predictable effect on prices.

This “full-or-empty” phenomenon is particularly apparent in media savants' explanations for each day's market movement. In “up” times, a strong report on consumer income is interpreted as fueling corporate sales and profits, and thus is used to explain rising stock prices. In “down” times, on the other hand, the same report may be cited as a cause of inflationary pressure, rising interest rates, lower p/e ratios, and thus declining stock prices.



“Everything that was good for the market yesterday is no good for it today.”

Valuing the Future – Credence or Skepticism

Some investors spend their time working hard to quantify this year's earnings and the growth thereafter. Others strive to value real assets, intellectual property and business advantages (and predict what others will pay for them). Still others try to deduce the value implications of mergers and acquisitions, balance sheet restructurings and private-to-public transactions. **In all of these ways and many more, it's the job of those in the investment business to predict the future and put a value on it.**

In 2000-01, our distressed debt funds invested a few hundred million dollars in bankrupt telecom companies. In each case, the purchase price implied a value for the company that was a small

fraction of the amounts that had been invested in hard assets such as switching gear or fiber-optic cable. If we could resell the equipment for a higher percentage of its cost than we had paid, the investment would be profitable.

The first sale went well, and we made a quick 50%. But soon thereafter, people stopped showing up to bid on these assets. Whereas the party to whom we had sold the first company thought he had a bargain, in later instances the possible buyers shied away from assets that were turning out to be in heavy oversupply. And that brings me to my point. In 1999, investors accepted at face value their telecom companies' rosy predictions of the future and paid handily for that potential. In 2001, they saw the potential as largely empty and wouldn't pay a dime for it, given that the industry's capacity vastly exceeded its current needs and no one could imagine the excess being absorbed in their lifetime. **This cycle in investors' willingness to value the future is one of the most powerful that exists.**

A simple metaphor relating to real estate helped me to understand this phenomenon: **What's an empty building worth?** An empty building (a) has a replacement value, of course, but it (b) throws off no revenues and (c) costs money to own, in the form of taxes, insurance, minimum maintenance, interest payments, and opportunity costs. In other words, it's a cash drain. When investors are in a pessimistic mood and can't see more than a few years out, they can only think about the negative cash flows and are unable to imagine a time when the building will be rented and profitable. But when the mood turns up and interest in future potential runs high, investors envision it full of tenants, throwing off vast amounts of cash, and thus salable at a fancy price.

Fluctuation in investors' willingness to ascribe value to possible future developments represents a variation on the full-or-empty cycle. Its swings are enormously powerful and mustn't be underestimated.

Value Investing vs. Growth Investing – (or Value Today vs. Value Tomorrow)

Interest in "value investing" versus "growth investing" is another phenomenon that fluctuates over time, with the relative popularity of growth investing based heavily on investors' willingness to value the future. It's not just a random fad, but a reflection of a cycle in attitudes.

In my view, all investors try to buy value – that is, to buy something for less than it'll turn out to be worth. The difference between the two principal schools of investing can be boiled down to this:

"Value investors" buy stocks (even those whose intrinsic value may show little growth in the future) out of conviction that the current value is high relative to the current price.

"Growth investors" buy stocks (even those whose current value is low relative to their current price) because they believe the value will grow fast enough in the future to produce substantial appreciation.

Thus, it seems to me, the choice isn't really between value and growth, but between value today and value tomorrow. Growth investing represents a bet on company performance that may or may not materialize in the future, while value investing is based primarily on analysis of a company's current worth.

Certainly much of the fluctuation in the performance of one school versus the other stems from their relative price attractiveness: one group of stocks may be perceived as the cheaper of the two and thus begin to be bought more strongly. This buying makes it appreciate relative to the other until it gets ahead price-wise, and then it declines (or at least pauses) while the other catches up.

But the two schools' relative performance also depends to a great extent on attitudes that fluctuate cyclically. Optimistic growth investors with big dreams for the future bid up the stocks of companies that they expect to exhibit rapid growth, as they did in 1998-99. Eventually their buying power is spent, their hopes are dashed, or their optimism wanes. Then value investors with their more limited expectations regarding the future have their day in less buoyant times, as they did in 2000-01.

Selling Panic (and Its Less-Recognized Brother)

As the pendulum makes its periodic swing from positive to negative, the resurgence of fear, risk aversion, and attention to things missing from the glass combine to bring down prices. Most investors see their resolve evaporate, along with all their reasons for holding the things in their portfolios. They go from being confident partisans, to worriers, eventually to sellers – and sometimes to panic sellers.

In November 2000, I wrote about “A Framework for Understanding Market Crisis,” an insightful article by Richard Bookstaber, then of Moore Capital Management, that analyzed the behavior of panic sellers. Rather than reinvent the wheel, I'll excerpt from my earlier memo:

- Most people think security price movements result primarily from the market's discounting of information about corporate, economic or geopolitical events – so-called “fundamentals.” If you sit with a trader, however, it's easy to observe that prices are always moving in response to things other than fundamental information.
- Bookstaber says, “the principal reason for intraday price movement is the demand for liquidity In place of the conventional academic perspective of the role of the market, in which the market is efficient and exists solely for informational purposes, this view is that the role of the market is to provide immediacy for liquidity demanders **By accepting the notion that markets exist to satisfy liquidity demand and liquidity supply, the framework is in place for understanding what causes market crises, which are the times when liquidity and immediacy matter most.**”
- “Liquidity demanders are demanders of immediacy.” I would describe them as holders of assets in due course, such as investors and hedgers, who from time to time have a strong need to adjust their positions. When there's urgency, “the defining characteristic is that time is more important than price **they need to get the trade done immediately and are willing to pay to do so.**”
- Usually when the price of something falls, fewer people want to sell it and more want to buy it. But in a crisis, “market prices become countereconomic,” and the reverse becomes true. “A

- In times of crisis, liquidity suppliers become scarce. Maybe they spent their capital in the first 10% decline and are out of powder. Maybe the market's increased volatility and decreased liquidity have reduced the price they're willing to pay. And maybe they're scared, too. **“Information did not cause the dramatic price volatility. It was caused by the crisis-induced demand for liquidity at a time that liquidity suppliers were shrinking from the market.”**

Speaking of panics, we all recognize the carnage that occurs when the desire to sell far exceeds the willingness to buy. But I think Bookstaber's analysis applies equally to the opposite – times when the desire to buy outstrips the willingness to sell. It amounts to a **“buying panic”** and represents no less of a crisis, even though – because the immediate result is profit rather than loss – it is discussed in different terms. **Certainly 1999 was just as much a year of irrational, liquidity-driven crisis as was 1987.**

And clearly, both selling panics and buying panics have more to do with extreme swings in emotion and urgency than they do with fundamental corporate and economic developments.

The Credit Cycle

I couldn't leave the subject of cycles without touching on one of the most pronounced, the credit cycle. From time to time, providers of capital simply turn the spigot on or off – as in so many things, to excess. There are times when anyone can get any amount of capital for any purpose, and times when even the most deserving borrowers can't access reasonable amounts for worthwhile projects. **The behavior of the capital markets is a great indicator of where we stand in terms of psychology and a great contributor to the supply of investment bargains.**

The level of security issuance varies over time in a wave-like pattern, and the swing from high years to low years can be great. I don't believe a high level of issuance says much about the desire of companies to raise money; usually they'll take all that's available. Rather, a high level of issuance indicates a willingness on the part of investors to buy increased amounts of securities, something that varies greatly depending on their mood.

But equally important is the trend in the quality of new issue securities. **It is my belief that a willingness to buy new securities in greater quantity invariably is accompanied by a willingness to buy securities of lower quality.** Thus lower standards go hand in hand with higher amounts of issuance. When investors are chastened and afraid, they'll buy very few new securities, and only those of high quality. When they're euphoric and confident, they'll buy greater quantities and attend less to matters of quality and downside protection. **In the most overheated markets, when being underinvested is considered the biggest mistake one can make, buyers compete for new issues by paying higher prices and by demanding less in terms of quality and safety.**

It's in this way that the swing of the capital market pendulum to one extreme provides the energy for the swing back toward the other. For example, with terrified high yield bond investors hugging the sidelines in 1990-91, low issuance and a great degree of investor selectivity set the stage for low subsequent default rates and excellent portfolio performance. Double-digit returns in 1991-97 (save 1994) turned investors from cautious to confident and attracted increased capital for investment in high yield bonds. These conditions led to the issuance of bonds in greater quantity and lower quality in 1997-99. And, of course, that issuance contributed to record default rates in 2001-02, to great portfolio losses, and eventually to enormous returns on the rebound. And so the cycle goes on.

From the depths reached in the summer of 2002, the recovery of investor sentiment has been dramatic in both its extent and its speed. And with that recovery has come yet another dramatic swing of the capital cycle from restrictive to accommodating. Again as seen through the example of high yield bonds, the last eighteen months have witnessed a near-record amount of new bond issuance, including a large number of CCC-rated bonds, bonds with weak covenants, and bonds issued to fund payments to equity holders.

All net debt incurrence adds to a company's riskiness, in that it increases balance sheet leverage. But at minimum the proceeds, or assets bought with the proceeds, should stay within the company. When debt is raised and the proceeds go out the door without enhancing the value of the company, a transaction should be viewed with a particularly critical eye. The fact that a substantial number of bonds-for-dividends deals could be done in recent months says a lot about where we stand in the credit cycle . . . and about the likelihood that some of these deals will be grist for distressed debt investment in the future.

Looking for the cause of a market extreme usually requires rewinding the videotape of the credit cycle a few months or years. Most raging bull markets are abetted by an upsurge in the willingness to provide capital, usually imprudently. Likewise, most collapses are preceded by a wholesale refusal to finance certain companies, industries, or the entire gamut of would-be financiers.

The capital market oscillates between wide open and slammed shut. It creates the potential for eventual bargain investments when it provides capital to companies that shouldn't get it, and it turns that potential into reality when it pulls the rug out from under those companies by refusing them further financing. It always has, and it always will.

Just Give Me My 10%

Putting it all together, the fluctuations in attitudes and behavior described above combine to make the stock market the ultimate pendulum. In my 34 full calendar years in the investment business, starting with 1970, the annual returns on the S&P 500 have swung from plus 37% to minus 26%. Averaging out good years and bad years, the long-run return is usually stated as 10% or so. Everyone's been happy with that typical performance and would love more of the same.

But remember, a swinging pendulum may be at its midpoint "on average," but it actually spends very little time there. The same is true of financial market performance. Here's a fun question (and a good illustration): for how many of the 34 years from 1970 through 2003 was the annual return on the S&P 500 within plus or minus 2% of "normal" – that is, between 8% and 12%?

I expected the answer to be “not that often,” but I was surprised to learn that it had happened **only once!** It also surprised me to learn that the return had been more than 20 percentage points away from “normal” – either up more than 30% or down more than 10% – two-thirds of the time: 22 out of the last 34 years. So one thing that can be said with conviction about stock market performance is that **the average certainly isn’t the norm.** Market fluctuations of this magnitude aren’t nearly fully explained by the changing fortunes of companies, industries or economies. They’re largely attributable to the mood swings of investors.

Lastly, the times when return is at the extremes aren’t randomly distributed over the years. Rather they’re clustered, due to the fact that investors’ psychological swings tend to persist for a while – to paraphrase Herb Stein, they tend to continue until they stop. Not one of those 22 extreme up or down years was more than a year away from another year of similarly extreme performance **in the same direction.**

* * *

So from time to time we see rabid buyers or terrified sellers; urgency to get in or to get out; overheated markets or ice-cold markets; and prices unsustainably high or ridiculously low. **Certainly the markets, and investor attitudes and behavior, spend only a small portion of the time at “the happy medium.”**

What does this say about how we should act? Joining the herd and participating in the extremes of these cycles obviously can be dangerous to your financial health. **The markets’ extreme highs are created when avid buyers are in control, pushing prices to levels that may never be seen again. The lows are created when panicky sellers predominate, willing to part with assets at prices that often turn out to have been grossly inadequate.**

“Buy low, sell high” is the time-honored dictum, but investors who are swept up in market cycles too often do just the opposite. The proper response lies in contrarian behavior: buy when they hate ‘em, and sell when they love ‘em. “Once-in-a-lifetime” market extremes seem to occur just once in a decade or so – not often enough to build an investment career around capitalizing on them. But attempting to do so should be an important component of any investor’s approach.

Just don’t think it’ll be easy. You need the ability to detect instances in which prices have diverged significantly from intrinsic value. You have to have a strong-enough stomach to defy conventional wisdom (one of the greatest oxymorons) and resist the myth that the market’s always efficient, and thus right. You need experience on which to base this resolute behavior. And you must have the support of understanding, patient constituencies. Without enough time to ride out the extremes while waiting for reason to prevail, you’ll become that most typical of market victims: the six-foot tall man who drowned crossing the stream that was five feet deep on average. **But if you’re alert to the pendulum-like swing of the markets, it’s possible to recognize the opportunities that occasionally are there for the plucking.**

July 20, 2004

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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

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Memo to: Oaktree Clients
From: Howard Marks
Re: Risk and Return Today

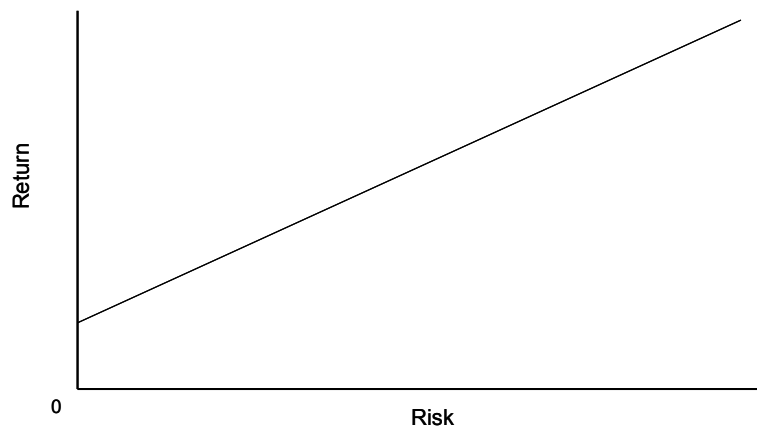
A single word is enough to describe the overall investment world today: lackluster. Stock and bond returns thus far in 2004 are quite modest virtually across the board. Candid managers almost everywhere admit there's little to buy. In many areas, especially in non-traditional investments, everyone agrees there's "too much money chasing too few ideas." How can everything be priced to provide low returns? Where does this excess money come from? I'll provide my explanation below. Pardon me if I start with some rudimentary building blocks.

Risk/Return Foundations

The most fundamental assumption underlying investment theory and practice today regards the universality of risk aversion. It is assumed that people dislike risk and prefer safety. The proof is simple: if a safe investment and risky investment – e.g., a 30-day U.S. Treasury bill and a start-up company's 30-year bond – both offer a 5% yield, virtually no one will choose the latter.

Thus, if investors are going to bear risk, they must be induced to do so, with the incentive coming in the form of a higher expected return. In short then, the market must set prices such that investors will expect riskier investments to deliver higher returns. (I have said many times that those higher returns must not be viewed as dependable; if risky investments could be counted on to produce higher returns, they wouldn't be risky. Thus their expected returns must appear to be higher in order to attract capital, but the higher expected return will always be accompanied by a range of possible outcomes that is wider and may include losses.)

Because of the assumed correlation between perceived risk and perceived return potential, the following graphic has come into widespread use to depict the market's basic workings:



As the graphic suggests, there is a low return that can be earned on the riskless asset and, from there, prospective return will rise with prospective risk. Thus we have a “capital market line” that, as the academics say, “is upward sloping to the right.” (The “riskless asset” is generally felt to be the shortest U.S. Treasury bill, with regard to which investors don’t worry about credit risk or the risk that inflation will erode the purchasing power of principal before it’s repaid upon maturity.)

The Market at Work

I’ll use a “typical” market of a few years back to illustrate how this works in real life: The interest rate on the 30-day T-bill might have been 4%. So an investor says, “If I’m going to go out five years, I want 5%. And to buy the 10-year note I have to get 6%.” He demands a higher rate to extend maturity because he’s concerned about the risk to purchasing power, a risk that is assumed to increase with time to maturity. That’s why the yield curve, which in reality is a portion of the capital market line, normally slopes upward with the increase in asset life.

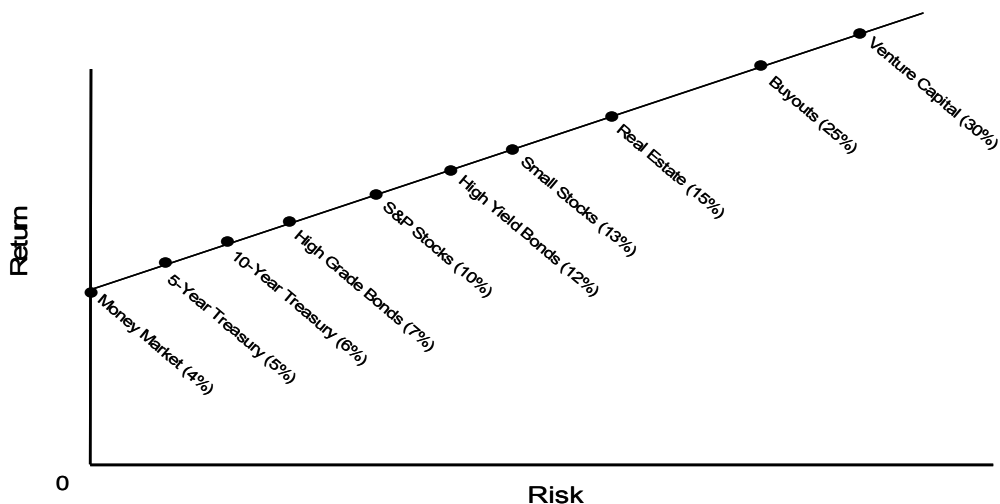
Now let’s factor in credit risk. “If the 10-year Treasury pays 6%, I’m not going to buy a 10-year single-A corporate unless I’m promised 7%.” This introduces the concept of credit spreads. Our hypothetical investor wants 100 basis points to go from a “guvvie” to a “corporate.” If the consensus of investors feels the same, that’s what the spread will be.

What if we depart from investment grade bonds? “I’m not going to touch a high yield bond unless I get 600 over a Treasury note of comparable maturity.” So high yield bonds are required to yield 12%, for a spread of 6 percent over the Treasury note, if they’re going to attract buyers.

Now let’s leave fixed income altogether. Things get tougher, because you can’t look anywhere to find the prospective return on investments like stocks (that’s because, simply put, their returns are conjectural, not “fixed”). But investors have a sense for these things. “Historically S&P stocks have returned 10%, and I’ll only buy them if I think they’re going to keep doing so.” So in theory, the common stock investor determines earnings per share, earnings growth rate and dividend payout ratio and inputs them into a valuation model to arrive at the price from which S&P stocks will return 10% (although I’m not sure the process is nearly that methodical in actuality). “And riskier stocks should return more; I won’t buy on the NASDAQ unless I think I’m going to get 13%.”

From there it’s onward and upward. “If I can get 10% from stocks, I need 15% to accept the illiquidity and uncertainty associated with real estate. And 25% if I’m going to invest in buyouts . . . and 30% to induce me to go for venture capital, with its low success ratio.”

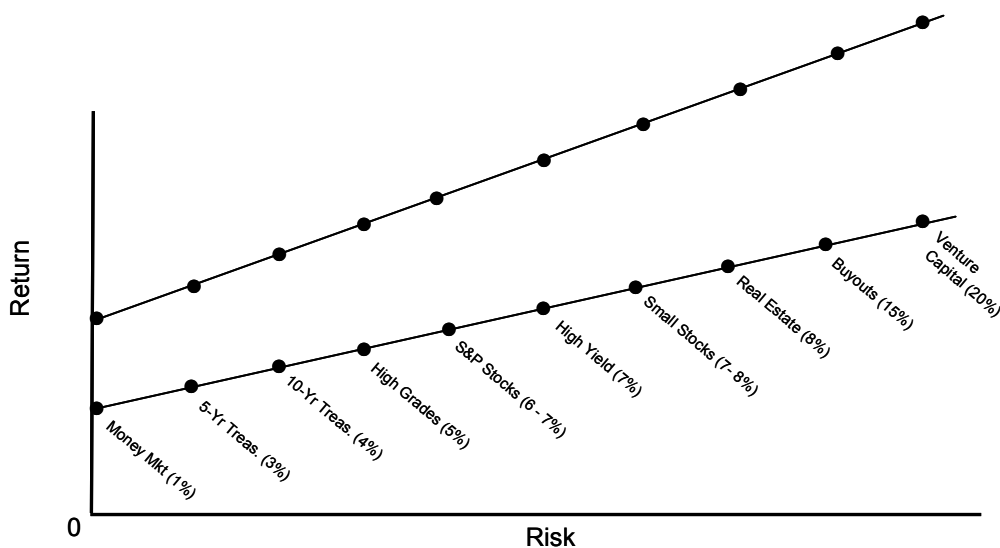
That’s the way it’s supposed to work, and in fact I think it generally does (although the requirements aren’t the same at all times). The result is a capital market line of the sort that has become familiar to many of us, as shown on the next page.



The Market at Work – 2004 Version

A big problem for investment returns today stems from the starting point for this process: The riskless rate isn't 4%; it's closer to 1%. Interest rates reached multi-generational lows in 2004. The Fed kept short rates low for much of the year, although they've been inching up in recent months. This was done (a) to stimulate an economy that has been quite sluggish since the last recession and (b) to protect the economy against negative effects from exogenous shocks, most prominently the corporate scandals of 2001-02 and the terrorist attacks of 9/11 (and the possibility of more); in fact, the low rates have been described as "emergency rates."

Our typical investor still wants more return if he's going to accept time risk, but with the starting point at 1+%, now 4% is the right rate for the 10-year (not 6%). He won't go into stocks unless he gets 6-7%. And junk bonds may not be worth it at yields below 7%. Real estate has to yield 8% or so. For buyouts to be attractive they have to appear to promise 15%, and so on. **Thus we now have a capital market line like the one shown below that is (a) at a much lower level and (b) much flatter.**



The lower level of the line is explained by the low interest rates, the starting point for which is the low riskless rate. After all, the investment thought process is a chain in which each investment sets the requirement for the next. Each investment has to compete with others for capital, but this year, due to the low interest rates, the bar for each successively riskier investment has been set lower than at any time in my career.

Why a Flatter Line?

Not only is the capital market line at a low level today in terms of return, but in addition a number of factors have conspired to flatten it. **First, investors have fallen over themselves in their effort to get away from low-risk, low-return investments. When you're especially eager not to make safe investment A, it takes less compensation than usual (in terms of prospective return) to get you to accept risky investment B.** Because people today are so motivated to get away from 1% money market investments and 3-4% Treasury notes, they'll accept less risk compensation than usual.

Second, risky investments have been very rewarding for more than twenty years and did particularly well in 2003. With only occasional, easily forgotten exceptions, we've seen high returns from common stocks, low-quality stocks, emerging market stocks, high yield bonds, distressed debt, private equity . . . the list goes on. **Thus investors are attracted more (or repelled less) by risky investments than perhaps might otherwise be the case and require less risk compensation to move to them.**

Third, investors perceive risk as being quite limited today. Because rising inflation isn't seen as a significant risk, bond investors don't require much of a premium to extend maturity. And because the combination of a recovering economy and an accommodating capital market has brought default rates to record lows, investors are unconcerned about credit risk and thus are willing to accept below-average credit spreads. **Prospective return exists to compensate for perceived risk, and when there isn't much perceived risk, there isn't likely to be much prospective return.**

In summary, to use the words of the "quants," risk aversion is down. In May 2003 we at Oaktree began to worry about investors' indiscriminate behavior (of course, we're usually early in worrying about overheated markets). We were struck by the rapidity with which the terrified investors of less than a year earlier had become confident and aggressive. "Stressed" bonds that we had bought at yields of 30% to 70% in the summer of 2002 now could be sold at yields of 6% to 9%. Somehow, in that alchemy unique to investor psychology, "I wouldn't touch it at any price" had morphed into "looks like a solid investment to me." As a result, money was flooding out of low-yielding safe investments and into risky investments that appeared to offer higher returns (although we didn't think the returns were high enough).

In response, I wrote a piece called "The Cat, the Tree, the Carrot and the Stick" as part of my memo "What's Going On?" published on May 6, 2003. I said I thought the combination of low prospective returns on safe investments and recent high returns on risky investments was pushing many investors to dangerously high branches of the investment tree. Those branches are subject to cracking under all that weight. Therefore, until conditions changed, I suggested something closer to the ground.

Money, Money Everywhere

But how can it be that there's too much capital trying to access so many markets at once? We can understand investor capital flowing from one market to another, but isn't the total amount of investment capital finite? Where does "more money" come from?

I think the amount of investment capital usually is rather fixed, (although many corporations are making pension fund contributions to correct under-funding), and in fact I don't think there's really "more money everywhere." It's just that no one wants to hold more cash at 1%, high grades at 3-5% or stocks at 6-7% (after stocks treated investors so poorly in 2000-02, that's what most people think they're now poised to return).

Thus I think the present situation is as follows:

- There's a given amount of money looking for a home.
- Relatively little of it is going into mainstream stocks and bonds, the two biggest markets.
- The redirection of that capital to the smaller non-traditional markets has given rise to a deluge capable of overwhelming those markets: driving up prices, lowering prospective returns and rendering attractive investments scarce as hens' teeth.

So it's not that there's that much more money around. **It's that would-be buyers are optimistic, unafraid, undemanding in terms of return, and moving *en masse* to small asset classes.** Holders of assets, who play a part in setting market prices by deciding where they'll sell, also are optimistic. The result is an unappetizing, risk-tolerant, high-priced investment landscape. It's for times like this that my favorite Warren Buffett quotation is most appropriate: **"The less prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own affairs."**

Implications for Investing

One way to improve investment results – which we try hard to apply at Oaktree – is to think about what "today's mistake" might be and try to avoid it. There are times in investing when the likely mistake consists of:

- not buying,
- not buying enough,
- not making one more bid in an auction,
- holding too much cash,
- not using enough leverage, or
- not taking enough risk.

I don't think that describes today. I've always heard that no one awaiting heart surgery ever complained, "I wish I'd gone to the office more." Well, likewise I don't think anyone in the next few years is going to look back and say, "I wish I'd invested more in 2004."

Rather, I think this year's mistake is going to turn out to be:

- buying too much,
- buying too aggressively,
- making one bid too many,
- using too much leverage, and
- taking too much risk in the pursuit of superior returns.

There are times when the investing errors are of omission: the things you should have done but didn't. Today I think the errors are probably of commission: the things you shouldn't have done but did. **There are times for aggressiveness. I think this is a time for caution.**

Not every investor has the option of holding a lot of cash. A pension fund has to pursue its actuarial return, and too many years spent earning money market rates can ensure it won't be achieved. The same can be true for a foundation that has to spend 5% of its assets each year, and for an individual living on his or her investment income. But when I look today at the smart people I know who have the ability to hold cash, I see large balances. As Warren Buffett wrote in his 2003 Annual Report, "Our capital is underutilized now It's a painful condition to be in – but not as painful as doing something stupid."

There are times when big funds are a good thing – when the market power that comes with more money is a help. I think this is generally a time for moderation in fund raising – a time when the selectivity and agility that come with smallness will prove to be key. Still, some managers are raising ever-larger funds and extending into new strategies on the back of recent strong results. That doesn't mean it's smart to join the herd of participants.

In my memo "What's Your Game Plan" on investing and sports (September 5, 2003), I mentioned the importance of "playing within yourself," or "not trying to do things you're not capable of, or things that can't be accomplished within the environment as it exists."

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.

No one wants to throw in the towel with regard to investment returns. No one likes to admit that their intelligence and hard work won't be enough to get them to their target. But at times when the markets are offering paltry absolute returns and inadequate compensation for bearing risk, it's the only thing to do.

What's the alternative? Deny the facts? Take on more risk in pursuit of high returns? Doing so won't help when prices are high and too much capital is jostling for admittance. **The fact is there are times when you have to stress caution, refuse to stretch for return, moderate your expectations, and keep your head down. I think this is one of those.**

By the way, I'm not saying all investments are priced too high and bound to collapse. I'm saying most aren't priced to give high returns or adequate risk compensation. Whether a strong price correction is coming in a given market depends on the extent and speed with which investors increase their return demands. Remember, there's only one way for prospective returns to increase quickly: through a price correction. On the other hand, a slow and gradual reassertion of prospective return can be accomplished through several years of price stagnation. Neither prospect, however, argues for aggressive investing today.

As for individual asset classes,

- The greatest excesses seem to be centered in some of the **alternative investments** to which people have fled in search of return. Private equity, distressed debt, hedge funds and others of that ilk are unlikely to prove the "silver bullets" that people are hoping for.
- There's no question that **bonds** of all stripes are fated to produce low returns – in fact, the lowest long-term bond returns I've ever seen. When you're talking about a 10% 10-year bond, you can argue about whether the return over the next few years will be 15%, 10%, 5% or zero. But when you're talking about a 5% bond, the range by definition has to be significantly lower.
- Finally, **stocks** are well down from their highs; their valuations have been rendered less excessive by today's generally higher corporate earnings; and they aren't being borne aloft by capital inflows. On the other hand, absolute p/e ratios are still high, supported by the low level of interest rates, and there's the risk of downward valuation when people realize that the long-term return on stocks is likely to be driven by profits growth in mid-single digits.

Taking all of the above into consideration, I feel this is a time when the route to investment success may be via the "least bad" course of action. **For over a year I've been telling the boards on which I serve that I view the solution as "special niches, special people." Because the vast majority of asset classes are high priced and crowded, the key is to find those that are less so. Similarly, it's important to choose managers with enough talent and discipline to make the most of the current situation.**

None of my observations is sure to be right, as always, but I want to share my thinking about what's going on in the investment markets today.

October 27, 2004

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Memo to: Oaktree Clients

From: Howard Marks

Re: Oaktree at Ten

Oaktree Capital Management, LLC opened its doors ten years ago, on April 10, 1995. That day represented a first step toward the founders' dream, which all of our colleagues embraced and implemented. In what truly feels like the blink of an eye, we've reached our tenth anniversary, and I'm writing to share our view of that first decade.

Priorities – Oaktree didn't start with a budget, a profit projection or a business plan. Rather, it was built on an investment philosophy and a set of business principles. When we started Oaktree, many people asked us about our motivation. We told them it was simple: we wanted a firm that would run our way. The things that constituted "our way" had been rattling around in our heads for many years and were the topic of many shared conversations. All that remained was to write them down and put them to work.

As you've heard *ad nauseum*, we chose to base Oaktree's approach to money management on a simple motto: "if we avoid the losers, the winners will take care of themselves." Thus we've endeavored to build portfolios that would give us acceptable performance if our expectations weren't fully realized, combined with the possibility of surprises on the upside if they were. We've strived to match market returns in good times and do markedly better in bad times – something that may sound simple but isn't. We chose to work in inefficient markets only, with portfolios that stick closely to their charter. Each of our portfolios is staffed by people dedicated to that market sector – who work hard to know more than others about companies, industries and securities, and who realize they can't get an edge with regard to macro forecasts and market timing. Thus our investment philosophy has provided a clear set of guideposts for Oaktree's people.

Equally important have been our business practices. Here the concepts are even simpler, but no less helpful: Portfolio decisions based on substantial investment in proprietary research. Conflicts of interest resolved in favor of the client every time. Compensation arrangements that align our interests with those of our clients. Thoroughly truthful communications and a pronounced refusal to downplay bad news. New strategies added only if they can be executed with risk under control. In 1995, we wrote that "The firm's profitability must stem from doing all the above. . . . Our earnings should grow if we achieve excellence in investing . . . but only then." We've all seen instances in recent years when gathering assets was accorded a higher priority than performing for clients – and headlines that were sad testimony to the result. I'm proud to say Oaktree's single-minded pursuit of its clients' interests has never been questioned.

We published our guiding principles in the spring of 1995 and literally haven't changed a word since (other than to add the criteria for new Oaktree strategies). And as we head into the second decade, we consider them just as applicable to the future as they have been in the past.

Clients – We felt going in that if we stuck to the rules we’d followed previously and delivered the same level of performance, the rest would come: we’d have a successful business on our hands. Happily, that’s what happened.

We are thrilled by the caliber of the investors we’re able to call our clients – the term “gilt-edge” seems inescapable: Twenty-four of the fifty largest corporate pension plans as of year-end 2004. The pension funds of twenty-two of the fifty states (plus many counties, cities and police and fire departments). Eighty-one college and university endowments. Many of the world’s leading charitable foundations and most sophisticated insurers. A Vanguard mutual fund. And a growing complement of high net worth investors. Here’s a fact for you: of the 25 pension plans with the biggest commitments to distressed debt according to Pensions & Investments, (a good indicator of investment sophistication, we think), 23 participate in at least one Oaktree strategy. Oaktree’s client roster represents the ultimate validation of our efforts as investment professionals. And it expands every year. In fact, we feel most ten-year-old money management firms would be happy to have a clientele consisting of just the accounts that join Oaktree in a typical year.

Even more important than the number of our clients is the quality of the relationships. Many have become true partners who extend a warm welcome, give our proposals the benefit of the doubt, believe us when we say something is true, provide their valuable counsel, and continue to broaden the list of things they do with us. As a result, on average our twenty largest client relationships encompass more than four of Oaktree’s twelve strategies. The reception we receive from our clients is truly one of our greatest sources of satisfaction.

Performance – Of course, we realize that these relationships stem only in part from the fact that our clients like us as people or share our philosophy. We’d be no place without performance. Thus we’re proud to be able to say we’ve achieved what we set out to do. We’d love to deliver great results every year, but that’s simply not possible. Instead, in short, it’s our goal to eliminate disasters, so that every year is either good or great. If a money management firm can do nothing other than produce returns that are at least decent every year, it’s sure to have an excellent long-term record. I truly can say my colleagues have done so, and that we’ve made money for our collective clientele every year since Oaktree opened its doors.

Including our time spent at TCW, we have well over 100 full calendar years of performance records: 19 years in high yield bonds, 18 years in convertibles, 16 years in distressed debt, and so forth. And of those 100-plus years, you’d have to stretch to find one or two when performance fell short of “at least decent,” by which we mean a return that’s good or great in either absolute or relative terms.

Likewise, I’m very proud to say that of the 24 closed-end funds we organized between 1988 and 2003, they’ve all been profitable, with net IRRs to date ranging from 4% to 49%. Again, good or great in every case, with no disasters.

Do we set the bar too low by pursuing performance that’s just “at least decent every year”? I don’t think so. First, I’m sure results of that sort in every year and every fund will give us one of the best long-term records. Second, I know of very few others operating in our fields who’ve done it as long without stumbling. And third, as far as I know no client has ever left Oaktree because they found our performance unsatisfactory. It may sound like a modest goal, but continuing to achieve it is one of my greatest aspirations.

Growth – Oaktree began ten years ago with seven “legacy” strategies: high yield bonds; U.S., international and high income convertibles; distressed debt; principal investments for corporate control; and real estate. We managed \$7 billion in these seven just before leaving TCW to start Oaktree, and we brought over at least \$6 billion. As of year-end 2004 they had grown to \$22.5 billion.

[This first mention of asset growth makes this is a good time for a key aside: we feel many of our best decisions have related to limiting the assets under our management. Marketing efforts in all four of the original “marketable securities” strategies have been curtailed from time to time. (In high yield bonds, for example, we’ve turned away or declined to compete for \$14 billion of new assets since November 1998.) All three of the original “private partnership” strategies have restricted the size of their funds to match the available market opportunities, with good results.]

After spending the years 1995-97 developing our infrastructure and attracting clients to the seven original strategies, we turned in 1998 to expanding our “product line.” In the seven years since, we’ve identified five new strategies that met our criteria (inefficient markets that offer the potential for superior risk-adjusted returns; a way to exploit them with risk under control; and people at hand who’re capable of doing so). Thus we began to manage assets in emerging market equities (1998), European high yield bonds (1999), buyouts in power infrastructure (1999), mezzanine investments (2001) and a credit-oriented hedge fund (2004), with results we’re proud of in every case. It has been our goal to offer helpful new strategies to our clients but not become a “fund-of-the-month club.” And we have required that every new strategy adhere to Oaktree’s investment philosophy.

The expansion of our offerings overlapped with our decision to look beyond the U.S. Before 1998, we had significantly invested abroad only in convertibles. But early that year we concluded that our strengths could be applied internationally. The steps in our internationalization have included the 1998 creation of a London office for the management of European high yield bond portfolios, which began in 1999; formation of our first emerging markets fund at the end of 1998 (which brought the establishment of our research office in Singapore); the creation of a Tokyo real estate office in 1999, which since has broadened its scope to include investments in Japanese corporations; and the initiation of rest-of-world marketing out of London in 2001. In 2004 we opened a Frankfurt office to pursue opportunities in real estate, private equity and distressed debt, and several of our strategies will see further internationalization in 2005 and beyond. The key is for us to remember that there are differences between these markets and the U.S., and thus to proceed cautiously, with the bar held high in terms of required returns.

Finally, we have responded positively to the growing opportunity available to us in serving high net worth investors. While our approach has never included advertising or promotion, we have benefited from word-of-mouth recommendation and from the prominent individuals who first learned of us through institutional relationships. Thus, from \$300 million at the end of 1995, our business with HNW investors has grown to \$1.1 billion today.

For us, Oaktree isn’t a “growth story.” We’ve never had goals in terms of growth rate or assets under management. Rather, we want to serve our clients where we have an advantage. We’ve always been certain that prudent expansion would lead to asset growth, and the results have been most positive: Of our year-end 2004 assets, \$5.2 billion (or 19%) was in the five new strategies mentioned above. Our investments outside the U.S. total \$7.1 billion, and assets managed for clients based abroad stand at \$2.5 billion. Thus, adding in the \$1.1 billion in high net worth

accounts (and even after eliminating the significant double counting among these numbers), it's clear that new directions have contributed a lot to Oaktree's growth in these ten years.

People – The irreplaceable element in producing these results has been people, and I couldn't be more proud of my colleagues. Oaktree started with 42 of us who had worked together at TCW, and we were greeted on that first day by the “advance party” consisting of Chief Financial and Administrative Officer David Kirchheimer (employee #1) and his support crew. The biggest surprise upon starting up was the amount of non-investment work there was to do, but David got us rolling and kept us there.

From that beginning we have grown to roughly 300 people. They're tops in terms of intellect, street smarts and character, and a pleasure to be around. The “second generation” both pushes and supports the first, and the “third generation” is right behind them every moment. I'm glad to say that, together, they have created the harmonious environment we wanted, in which team effort leads to excellent results. The investment management industry is full of brilliant people who can make you a lot of money but are tough to work with. I'm happy to say there aren't any at Oaktree.

And speaking of “happy,” I think our people are. That's very important – not just because we want happiness for them, but also because it'll make them the best for Oaktree and its clients. Our favorite indicator: we think the 139 babies born to Oaktree employees and their spouses in these ten years attest to a very positive mood.

What's the bottom line? All six of the Principals who started Oaktree with me in 1995 are still here. I've worked with my nine fellow Principals for a total of 127 years (exemplified by Sheldon Stone, with whom I'm about to celebrate my 22nd anniversary). In that time – believe it or not – there hasn't been a heated argument or difficult negotiation among any of the ten of us. In twenty years reaching back to our beginning at TCW, there have been only two departures of senior investment professionals that weren't by mutual agreement (excluding the emerging markets group, which has seen significant turnover). And everyone who managed a legacy strategy when we opened ten years ago still manages it today. Certainly none of this is “par for the course” in the turbulent investment industry.

Ownership – Initially, Oaktree was 100% owned by the founding Principals. Over the next ten years we sold roughly 25% to key employees at a price equal to one times the coming year's estimated earnings. This sharing of ownership has produced the desired results in terms of teamwork, satisfaction, shared motivation and personnel retention. We feel it's essential that Oaktree's employees work for the good of all clients, not just those in their own strategy. Broad ownership helps us ensure that.

As you know, a year ago we sold roughly 6% of the firm to seven long-term clients at its fair market value. Our objectives were achieved: personal diversification, of course, but – more importantly – demonstration, by posting a real-world price, that the 60 non-Principal owners had done well and been treated fairly. It's working entirely as we had hoped: the new investors are constructive but not intrusive. What could be better? Doubtless you will see further sales of ownership to third parties over time, but never transferring control. And of course ownership among employees will be broadened further. In short, we like the idea of working together, but not of working for someone else.

Plans for the Future – After reaching ten years and \$28 billion, we run into a lot of people who speak of Oaktree as an established investment institution. Happily, I can tell you my colleagues and I still think of it as a startup, and nothing could bode better for the future. It means we're still engaged and excited, still worried that being too relaxed or too confident could cause us to fail, and still thinking about rising to meet the challenges ahead.

Our goals for the future are simple: more of the same. Performance that's consistently either good or great. Relationships with terrific clients who always feel they're treated fairly. A harmonious workplace shared by bright, happy colleagues who pull together. And, as a result, prudent growth and continuing profitability. Who could ask for more?

The achievement of these goals will always be dependent on you, our clients. "We couldn't do it without you," may sound hackneyed, but nothing could be more true. For the ability to work for and with you, to visit and call you our clients, the people of Oaktree give their heartiest thanks.

April 11, 2005

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Memo to: Oaktree Clients
From: Howard Marks
Re: There They Go Again

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. . . . 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.

John Kenneth Galbraith
A Short History of Financial Euphoria, Viking, 1990

The above observation has appeared in lots of my memos, second only to Warren Buffett's reminder that our need for prudence in a given situation is inversely proportional to the amount of prudence being displayed by other investors. Neither of these favorite quotations says much for the average investor: Buffett urges us to adopt behavior that is the opposite of John Q. Investor's, and Galbraith points out how prone John Q. is to repeating the mistakes of the past.

It may sound cynical, but most outstanding investors – especially members of the “us school” (see “Us and Them,” May 7, 2004) – understand that the path to superior results lies in taking advantage of other people's mistakes. (The alternative is to think everyone can succeed simultaneously.) It's when most investors take a trend to excess, or the price of an asset to an extreme, that the few people smart and resolute enough to abstain from herd behavior can make truly exceptional profits.

I think both Buffett's and Galbraith's dim views of the average investor are well founded. Although there exist a few rules and reminders that can make it easier to avoid the costliest investing mistakes, most investors rarely heed them.

Investors truly do make the same mistakes over and over. It may be different people doing it each time, and usually they do it in new fields and in connection with new assets, but it is the same behavior. As Mark Twain said, “History doesn't repeat itself, but it rhymes.”

Rarely is the same error repeated in back-to-back years. Usually enough time passes for the repetitive pattern to go unnoticed and for the lessons to be forgotten. Often it's a new generation repeating the errors of their forefathers. But the patterns are there, if you observe with the benefit of objectivity and a long-term view of history.

Why do the mistakes repeat? That's a good question, but not much of a mystery. First, few investors have been around long enough to recognize reoccurrence of the errors of twenty or forty years ago. And second, the greed that argues for ignoring "the old rules" easily trumps caution; hope truly does spring eternal. That's especially true when the good times are rolling. The tendency to ignore the rules invariably reaches its apex in periods when following them has cost people money. It is thus, as Galbraith points out, that those who harp on the lessons of the past are dismissed as old fogies. What are some of the recurring mistakes investors make?

- **It's Different This Time** – Trends in investing are carried to their greatest (and most punishing) extremes by the belief that something has changed – that rules that applied in the past have been rendered obsolete by new circumstances. (E.g., the traditional standards for reasonable valuations weren't applicable to shares in tech companies whose products were likely to change the world.)
- **It Can't Miss** – The fact is, anything can miss. There's no asset so good or trend so strong that you can't lose money betting on it. No investment technique is guaranteed to deliver high returns or keep risk low. Smoothly functioning markets don't permit the combination of high return and low risk to persist – **good results bring in buyers who raise prices, lowering future returns and elevating risk.** It'll never be otherwise.
- **The Explanation Couldn't Be Simpler** – By this I mean to poke some fun at investors' tendency to fall for stories that seem true on the surface but ignore the workings of markets. The stage was set for some of the greatest debacles by platitudes that were easy to swallow – but too simplistic and, in the end, just plain wrong. These include "For a company with good enough growth prospects, there's no such thing as too high a price" (1969 and 1999) and "Emerging markets are a sure thing because of the terrific potential for growth in per capita consumption" (1994).
- **This Tree Will Grow to the Sky** – The fact is, no trend will go on unabated forever. Most trends are limited by cycles, which are caused by people's reaction to developments. Buyers, sellers and competitors respond to trends, altering the current landscape and the future.
- **The Positives of Today Will Still Be Positives Tomorrow** – From time to time, some combination of optimism and greed convinces people that the favorable elements in the current environment – responsible for today's high asset prices – will stay that way. **But (a) things usually turn less rosy, and (b) even before they do, investors take prices to levels that are too high even for today's positives.**
- **Past Returns Are a Good Guide to Future Returns** – The greatest bubbles stem from the belief that high returns in the past foretell high returns in the future. The most successful investors – the longest-term survivors – believe in just the opposite: regression to the mean. The things that have appreciated the most will slow down (or

- **It'll Always Beat the Cost of Borrowing** – Speculative behavior usually features the belief that assets will always appreciate faster than the rate of interest paid on money borrowed to buy them with. We saw a lot of this in the inflationary 1970s. But for the most part, **statements including the words “always” and “never” are usually a sign of trouble ahead.**
- **The Supply/Demand Picture Doesn't Matter** – The relationship between supply and demand determines the price of everything. **The higher the demand relative to the supply, the higher the price for a given asset or strategy. And, the higher the price, the lower the prospective return (all else being equal). Why can't investors remember these two absolute rules?**
- **Higher Risk Means Higher Return** – There are times, especially when the prospective returns on low-risk investments appear inadequate, when people reach for more return by going out further on the risk curve. They forget that riskier investments don't necessarily bring higher returns, just higher projected returns. Forgetting the difference can be fatal.
- **Anything's Better Than Cash** – Because it entails the least risk, the prospective return on cash invariably is lower than all other investments. But that doesn't mean it's the least desirable. There are times when the valuations on other investments are so high that they entail too much risk.
- **It May Be Too Good to Be True, But I Don't Want to Miss Out** – There've been lots of times in my career when people knew something was unlikely to keep working but jumped on the bandwagon anyway. Usually they did so because they thought there was a little bit more left in the trend, or because not being aboard – and watching from the sidelines while others got rich – had become too painful.
- **If It Stops Working, I'll Get Out** – When people invest despite obvious danger signs, they usually do so under the belief that they'll be able to get out when the market turns down. **They rarely ask how it is that they'll know to sell before others do, or to whom they'll sell if everyone else figures it out simultaneously.**

As I sit here in 2005, the picture seems “as plain as the nose on your face.” Investors have found new darlings – real estate, private equity, hedge funds and crude oil – to replace the favorites of ancient history (that is 1999) – technology-media-telecom, biotech and venture capital funds. As I read articles about the new favorites, I find myself saying one thing over and over: **“There they go again.”**

Is it really that hard to remember the events of six years ago? Or is it just so easy to overlook them for the sake of hoped-for profit? Whichever it is, I'm going to take some

time below to go through these areas and cite some rule violations I see occurring. (I'm not saying that these investment areas are without merit. It's just that I wince when I see uncritical analysis and unsupported conclusions.)

Let's take the example of **real estate**. Almost twenty years ago, real estate was the site of many classic mistakes, and lots of money lost. In the mid-1980s, institutional investors charged into real estate, under banners like "They're not making it any more" and "It's a good inflation hedge." What they missed was the fact that:

- while it's true that no one's making more land, there's a lot left to develop, and easy access to capital enables market-glutting buildings to be built on it,
- something's only an inflation hedge if bought at a fair price to start with, and
- unlike the 1970s, inflation wouldn't be an issue for the next twenty years, and thus inflation protection wasn't worth paying up for.

Tax reform in 1987 reduced the demand for tax shelter purposes, and the economic slowdown of the early 1990s turned real estate into a basket case. They still weren't making any more land, but that didn't help institutional investors avoid huge losses.

Today, real estate seems to be the site of investing error again – with no one harking back to the last time around. This is especially true in private homes, with individuals rather than professionals doing most of the "investing." They're lining up to buy houses (often before they're built) that they never expect to occupy, for holding periods too short to repay the transaction costs in the absence of substantial appreciation, and they're financing them with maximum floating-rate mortgages, minimum amortization and little or no money down.

On March 25, 2004, The New York Times compared attitudes toward home buying today and the "dot-com frenzy" of the late 1990s:

... perhaps the most troubling similarity, some analysts say, is the claim that the rules have somehow changed. In an echo of the blasé attitude that "new economy" investors took toward unprofitable companies, the growing ranks of real estate investors are buying houses they never expect to be able to rent at a profit. Instead, they think the prices of houses will just keep rising.

This paragraph points up a key error. In 1999, impassioned investors bought dot-com stocks, not to participate in the underlying companies' profit streams, but to sell them at higher prices. But what could be depended on to make their prices go higher, if not favorable trends in profits? In the same way, rational investors won't count on being able to sell a house at a profit because someone else will pay more for it, but rather because of an increase in its economic value (which usually can be seen in the obtainable rent).

In that vein, The Wall Street Journal of March 22 carried a story comparing the cost of buying and renting. A study of 21 markets by Torto Wheaton Research had found that rent on the average two-bedroom apartment was well below the mortgage payment on the median home. Now certainly the two may not be comparable, and the study ignored such factors as down payments, tax deductions, property taxes, maintenance costs and appreciation. But the most important observation is that, based on national averages, the relationship has changed substantially over the last four years: rent now averages 92% of mortgage payments, down from 102% in 2001.

This relative increase in mortgage payments indicates that today, home prices are based on lower “cap rates.” The capitalization rate on a piece of real estate is the yield implicit in the sale price. Thus a cap rate is analogous to the earnings yield on a stock, which in turn is the reciprocal of its p/e ratio. Bottom line: home prices have risen substantially relative to the underlying (or implicit) cash flows. According to another study, by M/PF YieldStar, the price of the average home rose 16.4% in 2003-4, while the average rent was flat. Certainly real estate valuation ratios are up.

Why are homebuyers paying these higher valuations? Here are some answers, in the form of statements quoted in the New York Times article cited above. How many of the investor errors enumerated on pages 2-3 do you see below?

It’s driven by the same forces [as drove the dot-com stocks]: that investments can’t go bad; that it has the potential to make you rich; that you’ll regret it if you don’t do it; that it looks expensive but really is not.

. . . a limited supply of land coupled with demand from baby boomers and foreigners [will] prolong the boom indefinitely.

I don’t think prices are going to fall, and I don’t think they’re even going to be flat.

It really is a very hot real estate market, and I don’t know how long it’s going to continue. But in the short run, why not profit from it?

I look at this as a short-term investment and plan to unload it as soon as things look dangerous.

I’d bet none of the people quoted above lost money in the last real estate cycle or learned the lessons of the past. **It’s for that reason that they’re prone to mistake the up-leg of yet another cycle for a new and permanent miracle. And so it goes.**

The commercial, retail and residential properties that professionals buy have escalated also – although not as crazily or with as much disregard for valuation. Nevertheless, cap rates are down in response to the general decline in interest rates, demanded returns and risk premiums. With returns on Treasury bonds at 4-5%, fully leased class “A” office buildings apparently look good at 6-7%.

As usual, James Grant supplies a trenchant analysis, this time in the April 25 issue of Forbes. His summary of what's going on in real estate highlights time-honored mistakes that are being repeated:

Markets look forward, except when they look backward. At this moment the real estate market is looking backward. . . .

Mistaking the past for the future, people are pouring money into houses, shopping centers, office buildings, hotels, anything with a front door and a roof. They are paying some of the fanciest prices on record.

Property bulls come in all sizes, shapes and net worths. "We are living with the greatest liquidity ever," an eminent REIT promoter was quoted as saying in March in the New York Sun. "We're not going to have a crash in the real estate market, there is too much liquidity."

Liquidity is a term of art. It means lots of money. It can also mean – and, in 2005, does mean – "low interest rates," "E-Z financing terms," "low dollar exchange rate" and "value investors go away." In an evident state of liquidity-induced euphoria, a Miami Realtor recently proclaimed to The New York Times, "South Florida is working off a totally new economic model than any of us has ever experienced in the past."

Not true. The "South Florida economic model" is the oldest in the book. An excess of dollars leads to a drop in interest rates. And a drop in interest rates to a rise in real estate prices. And a rise in prices to massive new building.

Only later does the same surplus of dollars cause a rise in the inflation rate. This leads to a rise in interest rates. And to a drop in real estate prices, with the market now oversupplied by all that new building.

In other words, we see some instances where investors in real estate are:

- failing to recognize the transitory nature of the factors supporting prices,
- taking comfort from rising prices while they should be alarmed,
- overlooking the lessons of history, and
- declaring "it's different this time."

As Grant points out, "over the last ten years, bricks and mortar had a cash on cash return averaging 3.3 percentage points above the yield on the ten-year Treasury note. . . . Today, the yield is just 1 percentage point more than that not-very-high number (the ten-year is quoted at 4.5%)." In other words, properties used to provide a solid 3.3% spread over perhaps 6% on the ten-year, for a total return approaching 10%. Now there's a narrow 1% spread over a low base rate . . . for a total current return of 5.5%. The bottom

line is that investors in real estate today have to stress value consciousness and selectivity.

It's not my intention here to pick on real estate in particular or to suggest that it's worse than other markets. It's just that the articles being written about it provide such good examples of some investors' error-proneness.

As I wrote in October, I think we're seeing much of the same in **hedge funds**. Investors here are ignoring price also – this time not relating to the underlying assets, but to fund managers' services. Out of frustration with public, long-only equities (based with the usual hindsight on the 2000-02 debacle), they're looking for the silver bullet in “alpha managers” and “absolute return strategies.” And they're suspending disbelief – just like they do at the movies – to accept that it's possible each year to find thousands of new above-average managers who are capable of piloting thousands of new hedge funds to high returns with low risk in increasingly competitive markets.

In recent weeks, **private equity** has shown up as the belle of the ball. Managers who startled the world with \$3-6 billion funds a few years ago are pursuing \$8-10 billion this time with good success. They're able to get it because of recent performance swollen by generous capital market conditions, aided by the assertion that few funds will be big enough to compete for the mega-deals. I don't say these arguments are invalid, but I wonder if investors are worrying enough about some potentially troubling factors:

- the fact that the funds' managers are targeting their lowest returns ever – even though few of their past funds may have achieved their targets,
- the impact on the market for companies of five new funds with \$50 billion to spend – and the possibly underrated likelihood that additional managers will crowd into the “mega” space (I still hold that when the best are closed, the rest will be funded), and
- the effect on the managers themselves of \$100-plus million per year in non-performance-based fees.

Lastly, the recent price surge has made **crude oil** fertile ground for simplistic platitudes and the resulting investor error. Not only aren't they making any more, but our consumption increases every day; rapid growth in China and India implies massive further increases in demand; and much of the supply is in unreliable hands. None of these factors can be disputed. The key question is, “What do they make oil worth?”

I think it's important to note that, unlike cash flow-positive companies and profit-producing companies, it's hard to state the intrinsic value of a commodity or currency. Are you persuaded by the arguments above? Sure you are – I am, too. Do they make oil a buy today, at \$51 a barrel? Certainly. But weren't they just as true a month ago, when oil hit \$58? Didn't they make it a buy then, too? Just as with gold and the Euro, it's hard to say what the right price is to reflect a given set of fundamentals, and whether the

market price is too high or too low. This inability allows prices to fluctuate much more than fundamentals, and makes profitable investment in these things challenging.

* * *

Lately I've been speaking a lot from my last general memo, "Risk and Return Today" (October 27, 2004). In it I expressed my view that (1) the Capital Market Line today is "low and flat," meaning prospective returns in almost all markets are among the lowest we've ever seen, and risk premiums the narrowest, and (2) if prospective returns should rise, it'll likely happen through price declines. Nobody yet has said they disagree with these statements, and I don't think they're just being polite.

But the hard question is, "What can we do about it?"

- Invest as if it's not true. The trouble with this is that "wishing won't make it so." Simply put, it doesn't make sense to expect traditional returns when elevated asset prices suggest they're not available. I was pleased to get a letter from Peter Bernstein in response to my memo, in which he said something wonderful: "The market's not a very accommodating machine; it won't provide high returns just because you need them."
- Invest anyway – accepting relative returns (and the possibility of capital losses.)
- Invest anyway – ignoring short-run risk and focusing on the long run. This isn't irrational, especially if you accept the notion that market timing and tactical asset allocation are difficult. But before taking this path, I'd suggest that you get a commitment from your investment committee or other constituents that they'll ignore short-term losses.
- Hold cash – but that's tough for people who need to meet an actuarial assumption or spending rate; who want their money to be "fully employed" at all times; or who'll be uncomfortable (or lose their jobs) if they have to watch for long as others make money they don't.
- Concentrate your investments in "special niches and special people," as I've been droning on about for the last couple of years. But that gets harder as the size of your portfolio grows. And identifying managers with truly superior talent, discipline and staying power certainly isn't easy.

The truth is, there's no easy answer for investors faced with skimpy prospective returns and risk premiums. But there is one course of action – one classic mistake – that I most strongly feel is wrong: **reaching for return**.

Given today's paucity of prospective return at the low-risk end of the spectrum and the solutions being ballyhooed at the high-risk end, many investors are moving capital to riskier (or at least less traditional) investments. But (a) they're making those riskier investments just when the prospective returns on those investments are the lowest they've ever been; (b) they're accepting return increments for stepping up in risk that are as slim as they've ever been; and (c) they're signing up today for things they turned down (or did less of) in the past, when the prospective returns were much higher. This may be exactly the wrong time to add to risk in pursuit of more return. You want to take risk when others are fleeing from it, not when they're competing with you to do so.

"If you can't get the return you need from safe investments, make risky investments." When put that way, it doesn't make much sense. In fact, it reminds me of my father's joke about the inveterate gambler who said, "I hope I break even, because I need the money."

* * *

If you look back at the recurring mistakes listed at the beginning of this memo, you'll see some common threads. They all express wishful thinking, an inevitable part of human nature. They stem from an excessive proclivity to believe the positives – and disregard the negatives – prompted by the desire to make money.

The key ingredients in being able to avoid these mistakes should be pillars in everyone's investment approach:

- awareness of history,
- belief in cycles rather than unabated, unidirectional trends,
- skepticism regarding the free lunch, and
- insistence on low purchase prices that provide lots of room for error.

Adherence to these things – all parts of the canon of defensive investing – invariably will cause you to miss the most exciting part of bull markets, when trends reach irrational extremes and prices go from fair to excessive. **But they'll also make you a long-term survivor. I can't help thinking that's a prerequisite for investment success.**

May 6, 2005

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Memo to: Oaktree Clients

From: Howard Marks

Re: A Case in Point

Last month, my memo “There They Go Again” discussed investors’ propensity to repeat certain classic mistakes. The biggest of these mistakes stem from some combination of too much enthusiasm, optimism, naiveté and greed and too little realism and skepticism. Although it comes in a wide variety of forms, the bottom line is usually a belief that the “silver bullet” is at hand: a surefire route to wealth without risk.

In recent years we’ve seen the elevation of one such particular strategy, and in recent months its defrocking. The subject is convertible arbitrage. Its story is worthy of review.

Background on Convertible Arbitrage (Perhaps More Than You Want)

Properly, arbitrage refers to the simultaneous purchase and sale of the same thing, or of two things that are nearly the same, at different prices so as to lock in a small profit on a highly probable basis. I was introduced to this phenomenon in the 1950s by an old movie about the Rothschild brothers, who spread out to five European cities and used information transmitted by carrier pigeon (at a time when there was no telephone or telegraph) to simultaneously buy and sell currencies in those far-flung cities at different exchange rates. Market opportunities are rarely that glaring nowadays, but they do arise from time to time.

Convertible securities are candidates for arbitrage because one asset (a convertible bond or preferred) is exchangeable for another (the underlying common stock). Thus imperfections in this market can create opportunities to simultaneously buy one asset and sell the other, giving rise to frequent small profits with little risk. Of course, the arbitrageur must be skillful enough to identify the opportunities and take advantage of them.

Time for an aside: Many years ago, Ed Thorp, an MIT professor of mathematics, literally “wrote the book” on blackjack. It’s called “Beat the Dealer.” Thorp used computers to simulate the play of the cards and codify the “basic strategy” that virtually all serious blackjack players use today to decide when to split, double down, hit or stick. Use of the basic strategy can significantly reduce (but not eliminate) the casino’s advantage. From quantifying the basic strategy, Thorp went on to formalize the process of card counting. Because blackjack is dealt from a deck or “shoe” without shuffling after every hand, the cards that have been played determine the cards that remain – in statistical terms, the hands aren’t “independent.” This means if a player can keep track of the cards that have been played, his knowledge of what remains can give him an advantage over the house. Recently the profitable use of card counting was chronicled in the enjoyable book “Bringing Down the House.” Card counting was used to such great advantage that casinos fought for, and won, the right to throw out counters.

Of course, when the casinos became able to evict card counters, they went straight for Ed Thorp. Needing a new “gig,” Thorp turned his attention to another field in which subjective judgment could be improved upon through computer simulation: convertible arbitrage (I’ll bet you were wondering what blackjack had to do with the subject of this memo). Thus Thorp pioneered the conversion from art to science of a second potentially profitable field.

In convertible arbitrage, someone buys a security that can be exchanged for common shares, and he sells short some of those same shares. Let’s say a bond is convertible into 40 shares and those shares are selling at \$20. Thus the value of the stock underlying the bond (the “conversion value”) is \$800. The bond usually won’t sell at \$800, but rather at some higher price.

One reason for this is that the bond embodies an option on that \$800 worth of stock (plus the means to pay for it by surrendering the bond). This combination is worth more than \$800, because an option provides a way to participate in an asset’s upside potential but not its downside. In addition, (a) a US convertible is likely to yield more than its underlying common stock, and (b) being senior to the common stock, it will entail less exposure to credit problems. So the bond may sell at \$1,000 when the common stock is \$20 and the conversion value is \$800. That implies a “conversion premium” of \$200, or 25% of the \$800 conversion value.

The arbitrageur buys the bond and shorts the stock. If the stock goes up (producing a loss in the short position), he expects the bond to go up almost as much (producing a gain in the “long” position). If he has more money invested in the bond than he does in the short position on the stock, the result can be reasonably attractive. If the stock goes down (producing a gain in the short position), he expects the bond – buoyed by the income and the promise of redemption at maturity – to go down substantially less (producing a smaller loss in the long position), for an overall result that is very positive. The arbitrageur hopes for a reasonable mix of appreciating stocks (with decent results on the arb positions) and declining stocks (with highly attractive results), and he has the ability to use leverage to magnify this steady flow of modest profits. In addition, he receives more income on the converts he owns than he owes on the stock he’s short. It’s hoped that the above elements will combine to produce a consistently positive return.

Obviously, the open question is how many shares to short in order to create the desired performance pattern. Because the relationship between the market price of the convertible and the market price of the shares isn’t constant, figuring out how much stock to short against a given bond purchase – the “hedge ratio” – has its vagaries.

Generally, a properly priced convertible will capture a certain percentage of the underlying stock’s gains and a somewhat smaller percentage of its losses. That means the percentage of the stock’s price movement captured by the bond is variable, rendering imprecise the proper number of shares to short per \$1,000 bond. And that number usually is less than the number of shares into which the bond is convertible. This is because convertible bonds are less volatile than the underlying shares, and the arbitrageur wants both sides of the position to be equally volatile. Thus he won’t short the full number of shares the bond is convertible into.

There's no one "right" answer regarding the hedge ratio. Setting it entails estimation regarding the future volatility of the common stock among other things. Thorp's methodology helped him to profitably determine hedge ratios.

The Backdrop

As the interest in hedge funds rose over the last ten years, "convert arb" became the model of an absolute return strategy. It seemed capable of grinding out returns in the teens almost every year. This occurred without significant exposure to market fluctuations, because every position was hedged.

The table below shows the 1995-2003 returns for the market-weighted index of convertible arbitrage funds in the CSFB/Tremont Arbitrage Index.

Year	Annual Return	3-Year Return	5-Year Return	9-Year Return
1995	16.6%			
1996	17.9			
1997	14.5	16.3%		
1998	-4.4	8.9		
1999	16.0	8.3	11.8%	
2000	25.6	11.7	13.5	
2001	14.6	18.6	12.8	
2002	4.0	14.4	10.7	
2003	12.9	10.4	14.4	12.8%

12.8% per year for nine years. Only one down year in nine, and that a loss of just 4.4%. No three-year period with an annualized return worse than 8.3%. No five-year period not in double digits. **What a record!!**

Rule Number One: Money Matters

So what happens? **Money floods in.** Whereas a few smart people had been able to churn out consistently good results with small amounts of capital, now a crowd was fighting over the convert arb ideas, armed with much more money. Increased pursuit of a strategy is sure to drive down prospective returns. If in a less crowded period the process of convertible arbitrage appeared capable of producing an inherent return in the low double digits (or maybe LIBOR plus 5%), it should be expected to produce less after others have flocked to it.

In addition, I feel arbitrage and many other hedge fund activities are best thought of as "piggybacking" strategies, living off some underlying process that has a life of its own (see the big fish/little fish analogy in "Hedge Funds: A Case For Caution"). What I mean is that as long as thousands of investors are setting the prices in the convertible bond and stock markets

through their buying and selling, a few dozen astute arbitrageurs can dart in on occasion to take advantage of their mistakes. But what if the arbitrageurs come to outnumber the “long-only” convert investors, so that their buying power directly affects (in this case, raises) the prices of convertibles relative to the underlying stocks. That can change the game, and thus the dependability and profitability of convertible arbitrage. This was certainly the case in 2004, when at times 80% of all convertible buying was thought to be from arbitrageurs. They didn’t care as much as the long-only crowd about the issuers and the price attractiveness of the underlying securities; rather, they would buy almost anything to put on an arb position.

When I organized Citibank’s first convertible fund in 1978, convertibles found few regular buyers and were considered a somewhat disreputable market of last resort for corporate financing. This level of disregard permitted convertible prices to languish. Most of the time I felt the convertibles I bought were considerably cheaper than a corresponding package of more efficiently priced bond plus stock from the same company.

For the next two decades, the same cheapness that had given our portfolios risk-adjusted returns better than stocks made it possible for convert arbitrageurs to buy underpriced convertibles and short fully priced common stocks. This was a formula for steady profits. But if money floods in such that bargains become less widespread among convertibles, it seems reasonable to suspect that convertible arbitrage will become less profitable.

In 2004, the return on the CSFB/Tremont convertible arbitrage index subsided to 2.0%. For the first four months of 2005, it was negative 5.8%. April was the fifth worst month out of the last 136. The index declined in only 14 of the 108 months from 1995 through 2003, but in 9 of the 12 months through April. January, February, March and April were all negative, the first time there have ever been four down months in a row. And May was the fifth – down almost 2% more. What changed? Mostly, I think, the amount of money being managed in the sector.

Bottom line: the returns available from an investment strategy are not independent of the amount of money seeking to be deployed in that strategy. **More simply put: everything else being equal, more money means lower returns.** This seems elementary, but it appears to be ignored every time something does well for a while. I repeat for the umpteenth time: what the wise man does in the beginning, the fool does in the end.

Rule Number Two: There’s No Sure Thing

If there’s a “kiss of death” in the investment world, it’s widespread belief that something can’t miss. When people have complete confidence in something, the prices they’ll pay for it and the amounts of money they’ll try to jam into it will sound an absolute death knell for its profitability. I’ve seen it in the nifty-fifty stocks, in oil stocks in the post-embargo 1970s, in disc drive companies, in portfolio insurance, in tech stocks and in venture capital.

In recent years, buying convertibles and shorting the underlying common shares came to be accepted as a surefire technique. And what could be better than having a long position in the senior securities of a company heading for trouble and a corresponding short position in its

common stock, with the likelihood that the stock would decline precipitously: no bet on the direction of the market or the company, and absolute preparedness for negative developments. That's the position the arbs flocked to this year in General Motors. They assumed the debt they were long would hold up much better than the common they were short. What could go wrong?

Well, something can always go wrong, and things are most dangerous when people agree they can't (and price them accordingly). In the case of GM, the arbs got a double whammy:

- Billionaire Kirk Kerkorian stunned the financial world on May 4 by announcing his intention to bid \$31 for 28 million shares of GM common stock. This drove the price of the stock from roughly \$28 to \$32, creating big losses on the arbs' short positions.
- Just the next day, S&P announced its long-expected downgrading of GM's credit rating. This lowered the price of GM debt, giving the arbs losses on their long positions as well.

In this way, something that "couldn't happen" did: the prices of both assets went against the arbs simultaneously. If a company's bonds decline because of deteriorating creditworthiness, can the stock possibly do better? It did this time – for a reason no one would have anticipated. (People are still mystified regarding Kerkorian's motivation.) I don't think a company's stock can do well for long if its bonds don't (given the implication of serious fundamental problems). **But the long run doesn't matter when unexpected difficulties arise in leveraged portfolios. The effect on staying power can be very negative.**

Other things we've seen recently that "couldn't happen": GM and GMAC being downgraded simultaneously, and intermediate and long rates down substantially while short rates rose more than 200 basis points.

As Long-Term Capital Management said in explaining its meltdown, "the convergence trades diverged." In this case, I absolutely am not saying the arbs were foolhardy in putting on their GM positions. I simply want to point out that nothing in the investment world can be counted on to work 100% of the time. Allowance must always be made for the unexpected.

Rule Number Three: Piling In Is Dangerous

One of the phenomena we've witnessed lately – and it was particularly pronounced in the events surrounding Long-Term Capital Management – is the tendency of funds of a given type to flock to the same situations. The General Motors trade described above, for example, was particularly common among arbs. Thus, when it went wrong, they all suffered losses, and they all faced illiquidity when they went to unwind it.

There's little mystery surrounding the reason particular trades become widespread. These days, computers are used universally – especially in the more quantitative fields – to screen for investment opportunities and model their profit potential. Not surprisingly, since they all sift through the same universes and evaluate profitability similarly, they often highlight the same investment opportunities. When everyone tries to pile in, that raises the cost of implementing

the strategy and thus lowers the prospective return. And when everyone wants to get out, that's costlier too. This is an example of the way in which too many piggybackers – with the same ideas – can overwhelm the underlying markets.

Rule Number Four: A “Virtuous Cycle” Can Turn Vicious

There is a predictable cyclical pattern in these matters, and now we've seen it in convertible arbitrage:

- In the years leading up to 2004, convertibles were available “too cheap,” and so arbitrage consistently produced high returns with low risk.
- The results were very attractive, drawing in capital.
- The new capital drove up prices, enhancing returns on existing positions.
- These returns attracted still more capital in a so-called “virtuous cycle.”
- When too much money came in, bargains became scarcer, causing the free lunch to be removed. Also, convert arb money altered the terms on new convertible issuance, reflecting the arbitrageurs' preference for call protection over yield.
- Positions put on in the new environment didn't do as well as the old ones.
- Investors' faith weakened in 2004 and largely evaporated in April/May 2005.
- Withdrawals set in for real: \$1.7 billion in the fourth quarter of 2004 and \$1.8 billion in the first quarter of 2005.
- The withdrawals caused forced selling, and the selling drove down prices, exacerbating the losses – and causing more loss of faith and thus more withdrawals and more forced selling.
- Now we think convertibles are getting cheap again, and we're considering increasing our allocation to them in our discretionary accounts.

* * *

It has always been thus, and it always will. Excessive confidence sets the stage for disappointment, and the loss of confidence creates bargains. It's the job of all investors to maintain their equanimity, buying in panics and selling in bubbles. **That'll be the day!**

Convertible arbitrage isn't “over.” The possibility of its application will always exist . . . but the assurance of high returns with low risk will not. They'll only be available when the amounts of money pursuing the strategy are reasonable, so that practitioners can be patient and selective and pick from an attractively priced universe. **And in that way convertible arbitrage isn't any different from any other investment technique.** Anyway, this isn't a memo about convertible arbitrage, but about investors' persistent mistakes. Convertible arbitrage is just a case in point.

June 6, 2005

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Memo to: Oaktree Clients
From: Howard Marks
Re: Hindsight First, Please (or, What Were They Thinking?)

“The farther backward you can look, the farther forward you can see.”
– Winston Churchill

I often cite John Kenneth Galbraith’s observation that one of the outstanding hallmarks of the financial world is “the extreme brevity of the financial memory.” Investors lose money over and over because they simply forget that cycles are inevitable and there’s no such thing as a free lunch. Now I’ve found a great quotation from Churchill, also reminding us that foresight comes largely from awareness of history.

Along similar lines, I’m struck by the extent to which a related factor, inadequate skepticism, also contributes to investment losses. Getting the most out of a book, play or movie usually requires “willing suspension of disbelief.” We’re glad to overlook the occasional plot glitch, historical inaccuracy or physical impossibility because it increases our enjoyment. When we watch Peter Pan, we don’t want to hear the person sitting next to us say, “I can see the wires” (even though we know they’re there). While we know boys can’t fly, we don’t care; we’re just there for fun.

But our purpose in investing is serious, not fun, and we must constantly be on the lookout for things that can’t work in real life. In short, the process of investing requires a strong dose of disbelief. **Time and time again, the post mortems of financial debacles include two classic phrases: “It was too good to be true” and “What were they thinking?” I’m writing to explore why these observations are so often invoked in the past tense.**

The combination of greed and optimism repeatedly leads people to pursue strategies they hope will produce high returns without high risk; pay elevated prices for securities that are in vogue; and hold things after they have become highly priced in the hope there’s still some appreciation left. Afterwards, hindsight shows everyone what went wrong: that expectations were unrealistic and risks were ignored.

It is my point that:

- **Investors mustn’t dwell excessively on recent experience.**
- **Instead, they must look to the future.**
- **They must consider today’s developments critically.**
- **That assessment must take place in the light of history’s lessons.**

All too often, investors' interest in the past is limited to the last few months or perhaps a year or two. They look unskeptically, are dazzled by the high returns they see, and jump aboard for more of the same. But they usually fail to consider longer-term history, which would show that "free lunches" never last forever. When the check ultimately comes in the form of losses, there's surprise and disappointment that could have been avoided.

Time after time when I read about trends being taken to excess – and later, when the painful consequences become clear – I find myself asking what they could have been thinking. **The alpha that's so much in demand today is really the ability to see ahead to things others will see only afterwards, in the rearview mirror.** The people of Oaktree spend a lot of their time figuring out what might be the next mistake and preparing for it. In other words, we try to anticipate – and avoid – pitfalls that others will rue after the fact.

Caveat Emptor

Today's financial *cause célèbre* is the Bayou group of hedge funds. Results were falsified and a lot of money has disappeared. It's easy to make a list of those who deserve blame in this affair, but few of the articles I see focus on the people I think should head the list: the funds' investors.

We live in an age when fingers are pointed at others all the time. Losers feel aggrieved and sue. That's what Bayou's investors will do, and certainly they were defrauded. But what was their part in the process? Where was their disbelief when they swallowed the following:

- They put their trust in a manager who claimed to have been a senior trader at Leon Cooperman's Omega Fund. But Leon – who denies that claim – says he got only one call over the years to verify it, while investors poured hundreds of millions into the fund.
- They invested in funds that executed trades through a brokerage firm owned by the funds' manager. Didn't they worry about the conflict that arises when a manager makes more money when his fund trades more often?
- They invested with managers who were the subject of complaints and lawsuits alleging improper conduct; these things can be checked out but apparently weren't. It seems investors took comfort from the fact that the brokerage affiliate was licensed by the NASD. What they missed, however, was the fact that the NASD would police the conduct of the brokerage arm but not the fund or its management.
- They went into funds whose auditors they'd never heard of. They couldn't have heard of them, because they'd never audited anyone. And if they had asked, they would've learned that the accounting firm's registered principal was the hedge fund's CFO.

- Some invested on the recommendation of people claiming to be hedge fund consultants. But in many cases these “advisers” disclosed that they were being paid by the funds they recommended. How could investors have relied on what so obviously could be biased advice?

In the case of Bayou – as in other scams before and others to come – it’s clear that a drawerful of cash provides a strong incentive to steal. But if that’s so obvious today, shouldn’t it have been obvious to people before they became investors? Shouldn’t that have encouraged caution? As The Wall Street Journal wrote on September 30 regarding Bayou’s founders, “Such tidbits from the duo’s business backgrounds were easy to find via Internet research and other inquiries.” **Thus the bottom line is a simple one, and instructive. Which of Bayou’s limited partners would have invested if they had known the above facts? And why didn’t they know them?**

Stocks for the Long Run

Going from the micro to the macro, another subject that suddenly looks a lot different in retrospect is the likely return on U.S. stocks. When I was in graduate school at the University of Chicago in 1967-69, I learned that its Center for Research in Security Prices had input the closing price for every stock every day since 1929 and computed that the average yearly return on U.S. equities had been a shade over 9%.

Later, a few more years of good returns had raised the historic figure – and thus expectations for future returns – to the range of 10-11%. **And from the late 1960s through the late 1990s, nothing – and I mean nothing – was more universal than the belief that stocks could be relied on for 9-11% per year. I don’t think I’ve ever seen an assumption that was less questioned than this one.**

The next step in cementing this expectation was the publication of “Stocks For the Long Run” by Wharton’s Jeremy Siegel, one of the nation’s highest-rated professors. Siegel’s message had the effect of minimizing worry about the variability of equity returns. He demonstrated with past data that stocks could be depended on to beat cash, bonds and inflation over the long term. In the popular perception, this morphed into an expectation that stocks could be depended on to beat cash, bonds and inflation . . . period.

Along with the boom in tech/media/telecom stocks and the first-day gains of IPOs, Siegel’s data contributed to one of the greatest equity manias of all times. Of course, it evaporated after the TMT stocks collapsed in 2000 and was buried as the major stock averages did the unthinkable, declining for three straight years for the first time since the Great Crash.

So what do people expect from stocks today? Equity investors now realize that p/e ratios are too high for multiple expansion to be counted on, and that dividend yields have declined from 4-7% in 1925-55 and 3-4% in 1955-95 to 1-2% in the last ten years. Thus,

they conclude they may have to look just to profits growth for their returns, and that's likely to be in the mid-single digits as usual. As a result, in my view, everyone's thinking 6-7%. No one's talking about 9-11% anymore.

What changed? There's nothing new about the argument contained in the paragraph just above. The cautious were making it in the 1990s. When stocks were rolling along, however, it had little persuasive power. **With stocks high, expectations regarding future returns were high.** The S&P 500 is 20% lower today than it was in 2000, on higher earnings, so it's demonstrably cheaper in p/e ratio terms (even if not necessarily cheap). **And with stocks lower, expectations regarding future returns are lower.**

Can there be a more clear-cut case of hindsight prevailing? I don't think so. And by the way, in the late '90s, people were sure stocks held the key to investment performance, and were pushing up their allocations. Some got to 80% just in time for the crash. I may not travel in the right circles, but it's been years since I last heard of an institutional investor that wants to increase its allocation to domestic equities. **If they're correct now, what were they thinking in the late '90s?**

If Not Stocks, Then What?

Since no one wants to increase allocations to U.S. stocks (or high grade bonds, for that matter), where's the money going? The answer is, just about anywhere else. Everyone knows there's too much money looking for a home in buyouts, venture capital, distressed debt, hedge funds, real estate, and on and on. But that isn't keeping more from flowing there.

I love that terrific Yogi-ism: No one goes there anymore; it's too crowded. **But the corollary is appropriate for the alternative investing world of today: Because it's so crowded, everyone wants to go there.**

Buyouts represent a great case in point today. It's a simple business (execution aside). You buy a company with a little equity and a lot of debt. If you buy it right, if you can make it a better company, and if you run into an environment characterized by a strong economy, freely available capital and rising asset prices, you'll be able to sell it for more than you paid for it, pay off the debt and enjoy a leveraged return. The theory is clear, but (like everything else in the investment world) it doesn't always work.

It worked very well from its inception around 1973 to roughly 1985, a period in which it was cheaper to buy a company through the stock market than start it and no one had ever heard of Henry Kravis. Then LBOs became enormously popular in the late 1980s, and companies were bought at ever-higher prices and ever-higher leverage ratios. Many of those went bankrupt in 1990 (causing a boom for distressed debt investors, but that's another story). That's what we call a full cycle.

Then a new cycle began, as it always will. Because the market was depressed in the early 1990s, as were investors, companies could be bought cheap again. And with both borrowers and lenders chastened, no one had to worry about deals becoming over-leveraged. When a lengthy economic recovery ensued, those deals did well. (Even in the next heyday for distressed debt investors – 2002 – very few buyouts went bad.)

But every trend eventually is carried to excess, and it's absolutely inevitable that "what the wise man does in the beginning, the fool does in the end." So now everyone thinks buyouts hold the answer again. Everyone's emboldened rather than chastened. And everyone's enticed by the recent returns, which in many cases have been eye-popping.

What's been happening? Simply put, the stars have been perfectly aligned for buyout success. In the recession, the scandals and the stock market malaise of the early 2000s, companies could again be bought reasonably. Lenders became motivated to put out capital, so higher leverage could be piled on at low interest rates. The economy turned strong, and business recovered. As increased capital flowed to buyout funds, the competition to buy companies – even from other buyout funds – drove up prices. And most crazily, lenders became willing to extend debt capital so that equity sponsors could take out their investment in short order. Nothing could be better for buyout returns than the ability to minimize your equity investment, increasing the extent to which returns are geared up. Thus the deals made in the last year or two have produced great returns.

But that doesn't mean the returns on deals made today and tomorrow will be similarly high. Will the favorable trends continue, or will they reverse? Will companies be costlier? Will interest rates rise? Will the economic environment continue to be salutary? Will leverage have the effect of magnifying gains or losses? Will the mega-fund managers do as well with \$10 billion funds in the environment of tomorrow as they did with \$3-6 billion in the past, with the stars aligned beautifully? **No one knows the answers, but investors should be asking these questions.**

I recently had a visit from the head of one of America's largest pension funds. He agreed with me that money is flowing to buyouts (and other forms of alternative investment) mainly because no one wants more mainstream stocks and bonds. He also pointed out that people are making these investments to capture the "illiquidity premium." The illiquidity premium and its cousin, the risk premium, are return increments that illiquid and risky investments should deliver to compensate for their illiquidity and riskiness. If return premiums couldn't be expected, investors wouldn't make those investments. **But the fact that something's illiquid or risky absolutely does not mean that a return premium can be depended on to materialize – and certainly not in short-run periods as brief as 5 or 10 years.**

It seems like a long time ago that people talked about the equity risk premium: the amount of return in excess of bond returns that stocks would deliver to compensate for their riskiness. But, again, the fact that it should have been there doesn't mean it was. In 2000-02, it certainly did not show up.

Investors should demand return premiums, but they shouldn't count on them. They should try to figure out whether they're in prospect – and as “prospect” implies, that's done by looking forward, not backward. The fact that return was there in the past doesn't mean it'll be there in the future. And, in fact, if too much return was earned in the past, that implies not much may be left for the future.

The Impact of Oil Prices

I'll try to be brief here. If I told you the government had just enacted a \$125 billion annual tax increase, you might think consumer purchasing would be crushed, business strangled and stocks beaten down.

Thus I'm incredulous that, with the price of oil (of which we import 12 million barrels a day) having risen from \$33/barrel in January 2004 to \$62 today, the stock market is still up (albeit not much). What is a price increase on imported oil other than an enormous tax increase, with the proceeds going abroad rather than to Washington?

Maybe I'm just looking for the next thing to worry about (as usual). But if the economy slows in 2006 or 2007 and security prices decline, and people explain it all by citing the increased cost of oil, I hope you'll remember to ask people what they were thinking in 2005.

By the way, I don't include this section because I want to discuss oil prices, but because the recent developments exemplify typical investor behavior. **When investors as a group are feeling upbeat, the market is able to shrug off negatives as isolated and insignificant. When they're depressed, investors generalize individual complications into an insurmountable web of negatives.** I feel it's very important that we be aware of whether the market is giving events their proper weight, versus overlooking or overrating them. When things develop that should be considered, it's a matter of “Pay me now or pay me later.”

We're from the Government and We're Here to Help

In 2002, at the height of the Enron/WorldCom corporate scandals, the federal government gazed unerringly into its own rearview mirror and demonstrated its ability to solve the last problem . . . and cause the next one. I've been looking for an opportunity to pop off on the subject of Sarbanes-Oxley, and here it is.

There was little discussion or dissent before Congress passed – and the president signed – this piece of legislation designed to root out corporate corruption and hold executives responsible for future infractions. The vote should tell you something: 423 to 3 in the House and 99 to 0 in the Senate! Any time the Great Deliberators on both sides of the aisle agree on something so overwhelmingly, it's probably being done in the heat of the moment and in response to rampant popular sentiment – and it's probably a mistake.

Let's look at the law's operation and effects. First, it required enormous one-time expenditures for the scrubbing of corporate books and the creation and assessment of control structures designed to avoid misdeeds. Second, it called for significant incremental ongoing expenditures along these lines.

At a conference I attended recently, a venture capitalist estimated that the average company with revenues of \$50-60 million faces increased costs of \$1-1½ million per year associated with being public. Larger companies are spending far more. I view this as an enormous tax on American business in perpetuity, and the benefits as far smaller than the cost.

When the hue and cry was at its apex and this law was enacted, a widespread epidemic of corruption was suspected. It turned out that the early reports were the worst, and few additional cases were detected in the mandated examinations that followed. So as a result of about \$10 billion in scandals – at Enron, WorldCom, Adelphia, Tyco and a few others – we've ended up with a law that will require the largely unproductive expenditure of many billions every year forever (or until rectified).

And it's not as if we had no laws on fraud before Sarb-Ox. They were there, and they were enforced. It's just that in 2002, citizens, and thus politicians, became frustrated with the fact that the old laws didn't prevent all fraud or keep CEOs from saying, "I had no idea that was going on." Thus the government moved precipitously to enact new laws. It's worth noting in this connection that the executives of Tyco, Adelphia and WorldCom all were successfully prosecuted under the preexisting laws, while the major alleged malefactor targeted under Sarb-Ox – Richard Scrushy of HealthSouth – escaped punishment altogether.

So has Sarb-Ox solved the problem? Mistakes made by generally honest managements will be identified in some cases, as they may have in the past, and some inept fraudsters will be caught. But I doubt the serious crooks will be prevented from taking a crack at robbing the cookie jar. And there is genuine risk that Sarb-Ox's single-minded emphasis on driving out fraud will have negative implications for corporate decision making.

What will be the effect of all of the above on companies' future development, and on the free enterprise system that has done so much for America heretofore? That's what our government should be emphasizing – not an overblown reaction to the scandals of the past. If the shortcomings of regulation can be reduced to one, I think it's the inability to anticipate second-order consequences. My advice to Washington (not that anyone's asking): don't look back at the problems of yesterday, but ahead to the impact of your "solutions."

Saving for Old Age

Henny Youngman used to tell about being stuck up at gunpoint. When asked for "Your money or your life," he answered, "Take my life; I'm saving my money for my old age."

Well, we rarely hear anymore about saving for old age. That's part of the financial prudence that has become hopelessly passé. After all, saving for later means consuming less today and delaying gratification, and those things are entirely out of style.

But then how do people expect to live in their old age? People seem to be retiring earlier, and certainly they're living longer. Medical advances are prolonging life but not getting any cheaper. With retirement lasting longer and entailing greater costs, how will people pay their bills?

Heretofore, the solution has been a stool with three legs: Social Security, private pensions and personal savings. How solidly constructed is the stool of today?

We've heard a lot about Social Security's woes. The number of active workers supporting each retiree is declining, threatening the system with insolvency a few decades out. After reading (and reviewing for the L.A. Times) Pete Peterson's excellent book "Running on Empty," I'm convinced we'll need some combination of higher taxes, delayed retirement or reduced benefits . . . but equally convinced that few politicians are going to commit career suicide by advocating tough medicine to solve a problem that's decades away. Not having to worry about reelection, President Bush came out of his 2004 victory willing to spend some political capital on his solution: the private retirement account. But no groundswell formed behind it, and other issues have taken center stage, and we haven't heard anything on this subject for months. One way or the other, I think retirees in the future will receive less from Social Security than the system promises today.

So what about private pensions? Defined Benefit plans are declining in popularity among employers, and a not-insignificant number are headed for insolvency. Defined Contribution plans are taking their place in many cases, but some of the bloom is off the rose now that "401-k" and "Acapulco" have ceased to be synonymous. Certainly their benefits are expected to be less lavish and less dependable now than was thought to be the case while the equity bubble of 1998-99 was in full flower.

And that leaves personal savings . . . which as a percent of income just went negative in July. I am amazed when I read about the people who spend all of their income and more on lifestyle. **Maybe they think old age won't come, but that's not a solution I'd be eager to rely on.** What about the millions – with no savings – who each year spend thousands of dollars more on their credit cards than they earn. How do they think this movie will end?

Anyway, early Baby Boomers like myself are probably well taken care of, because we partook of the post-war economic miracle before it had to be shared broadly and heeded the lessons of thrift taught by our Depression-era parents. But I worry deeply that those who retire in the 2020s and thereafter will find themselves without the resources they need. I also worry that the government will write checks to cover the shortfall. Compassion is a good thing, but swollen deficits, higher taxes and the implications of teaching people they don't have to save are all very bad.

When 2030 rolls around, with the centennial of the Depression, there's likely to be widespread wonder about what the non-savers of 2005 were thinking. I'd rather people started asking the relevant questions today.

You Can Always Live in It

Of course, the solution *du jour* for the question of wealth building is real estate. People are lining up to buy residences – especially condos – that they don't need, don't intend to occupy and can't rent out at prices providing a reasonable return on their investment, all in the expectation that they'll be able to sell them at a profit. That prompts me to coin a Yogi-ism of my own: My condo produces negative cash flow every month, but somebody else will pay me more for it than I paid.

My May memo "There They Go Again" discussed the residential real estate boom in depth, and I'm not going to repeat its message. Suffice it to say that "It can only go up," "It's been rising for months, but it's sure to keep going" and "If it starts to go down, I'll just get out" are routinely scoffed at after the fact.

What I want to review here is the extent to which people are buying highly appreciated properties that they couldn't afford if they had to pay full debt service on them on a current basis. This is entirely analogous to the highly leveraged buyouts of the 1980s that depended on zero-coupon borrowing. This debt was a big red flag: "I'm buying something I can't afford, with debt I can't service on a current basis, hoping positive developments will bail me out." Most of them went bankrupt in 1990 when the economy softened and debt couldn't be refinanced.

Now people are assuming increased financial risk to buy homes, often taking out interest-only loans at artificially low teaser rates. The September 2005 issue of *The Gloom, Boom & Doom Report* quoted Grant's Interest Rate Observer quoting David Rosenberg of Merrill Lynch:

- An estimated 42% of first-time buyers made no down payment on their home purchase in 2004.
- In the hottest price areas in the U.S.A., ARMs [adjustable rate mortgages] now account for over 50% of new mortgage originations.
- Over 60% of new mortgage loans in California this year have been interest-only loans or option ARMs.

People are stretching to buy the most house they can with the biggest mortgage payment they can afford. But if they can barely cover today's artificially reduced payments, what will they do when interest kicks in and/or rates rise? And what if their incomes fall? Where's the margin for error? When I was young, the rule of thumb was that no more than one-quarter of your paycheck should go for shelter. Today lots of people are paying more than half.

“Everyone knows” it’s better to make tax-deductible mortgage payments than to pay rent. But the beauty of financial puzzles is that there’s no answer that’s always correct regardless of the circumstances. I’d rather pay a low rent I’ll be able to afford even if things get a little worse than a high and possibly rising mortgage payment, on the continuation of which my home ownership is riding.

The old goal was to have the house paid off by retirement, so you could live in it when your paycheck stopped. Now, thanks to the magic of minimal down payments, minimal amortization and adjustable interest rates (starting from historically low levels), payments may well be higher in retirement than during the owners’ working years. How will people – possibly with little or no savings – hold onto their properties when their paychecks stop?

We never hear anymore about people “saving for a rainy day” or “saving for their old age.” If you do those things, it may be harder to get the house of your dreams . . . but you’ll never go broke. I wonder how many of today’s home buyers will learn this lesson through painful experience.

Selling Money

If a seller wants to move more of his product, what does he do? Well, that depends on whether the product is capable of being differentiated from its competitors. If it is, he can try making it better, advertising it more or improving distribution. But if it’s not differentiable, those things won’t work. Can you imagine the success that’s likely to come from an ad slogan like “Burn our natural gas; it’s better”? Goods that can’t be differentiated from their competitors are called commodities. If a seller of a commodity wants to increase market share and thereby sell more of his product, he has only one way to go: price it below the competition.

For the last two years, financial institutions have been able to make money by borrowing at short-term rates held down for stimulative purposes and lending at higher, longer-term rates. Thus, the institutions have battled to increase market share. But how could they do that, given that everyone’s money is green (and leaving aside the fact that it makes no sense for all participants to expect to increase market share at once)? The answer’s the same as for any other commodity: price it below the competition. In the case of financing, that means offering more of it for a given use, at lower interest rates, with looser terms and covenants.

As The Wall Street Journal of October 7 reported,

UAL had been shopping for \$2.5 billion of financing to fund its exit [from bankruptcy] **before competition among four financial institutions resulted in the larger [\$3 billion] loan package on “very competitive” terms**, the company said. . . . This is a very competitive rate in this

industry, [J.P. Morgan Vice President James] Lee said, noting that some recent airline financings have carried much higher rates. (Emphasis added)

When suppliers of capital are trying to pump out more money at lower rates, usually they also apply looser credit standards and offer easier terms. When that's the case, it's time to be a taker of capital, not a supplier. Our best investments have been made when suppliers of capital were shrinking from the market, refusing to lend or invest at any price. That means it's important, as in so many things, to look at the behavior occurring around you and ask one simple question: **“What kinds of times are these?”** The answer is usually clear, and thus so are the implications for the future.

But Does It Make Sense?

Ultimately, that's all you have to ask. The same October 7 issue of the Journal carried a story describing the efforts of mutual fund companies to offer “absolute-return” funds.

The bear market was “a wake-up call” for investors who previously were fixated on trying to earn as much or more as the surging stock market . . . Now, while investors may not recognize the terminology of absolute versus relative investing, “they just know they don't want to lose money.”

When the stock market was doing well, investors were pursuing high returns. Now, after some serious losses, they're pursuing safe, dependable returns. Even the Journal, not particularly known for cynicism, points out that, “the recent enthusiasm for absolute-return funds will fall by the wayside whenever the stock market takes off and market benchmarks rise far more than the gains at hedge-like funds.” **In other words, investors pursue safety when past results have been poor, but they lose interest in safety when past results have been good for a while. Not exactly contrarian, but the way it's always been. Investors have to learn that last year's return is not an indicator of next year's return, and thus of the appropriate strategy.**

And while I'm asking investors for more insight, I see the Journal goes so far as to point out that “it's also possible that the absolute-return vehicles won't achieve their stated objectives.” There's nothing new about investment managers falling short of their goals. Further, managing a portfolio of diverse asset classes and both long and short positions to produce steady returns regardless of the market environment is a particularly challenging task. Few people are able to do it successfully, and someone who can is more apt to work at a hedge fund charging “2-plus-20” than a mutual fund charging 1%.

In other words, I think most investors in these “absolute-return” mutual funds will find a few years from now that they didn't get what they wanted – that their returns were disappointingly low or disappointingly volatile (or both). **It would be great, instead, if they could ask today whether it's reasonable to expect consistent returns in the high**

single digits after significant fees. Otherwise they're likely to end up asking themselves – once again – “What was I thinking?”

* * *

The philosopher George Santayana is famous for having said, “Those who cannot remember the past are condemned to repeat it.” (Most apropos of this memo, but less famously, he also said, “Skepticism is the chastity of the intellect, and it is shameful to surrender it too soon or to the first comer.”)

The value of hindsight lies in the fact that lessons learned in the past by others can enable subsequent generations to avoid having to learn them anew. And yet, it seems investors must learn those lessons over and over – and often the hard way. The exact circumstances may not repeat, and the mistakes may not surround the same asset classes, but the general lessons of investing go on having to be learned. To avoid this, we have to improve on the brevity of memory that Galbraith complains about; refuse to surrender our skepticism; and learn to assess market behavior around us and extract the proper inferences for application to our own behavior.

Readers of my memos know I feel awareness and understanding of cycles is an essential tool for investment survival. I always say about cycles, “We may never know where we’re going, but we’d better have a good idea where we are.” Hindsight is helpful in this regard, not because the future will be exactly like the past, but because by learning the time-honored lessons of the past we can better cope with the uncertain future. Recognizing past patterns permits us to increase our preparedness, the payoff from which can be considerable.

Recent trends must not be counted on to continue unabated; that’s one of the main lessons of the long-term history that matters. A better understanding of that history tells us that every day of the recent past – and of current experience – is just another step toward the inevitable next cycle. **A critical analysis of the future will prove far more profitable than will unthinking adherence to the latest trend. But it’s the latter that always has dominated market movements, and that we have to watch out for.**

So every day when you read the newspaper, watch your Bloomberg or witness investor behavior, I encourage you to divine what those things say about what’s going on. That’s one way you can change your investing future for the better.

October 17, 2005

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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.

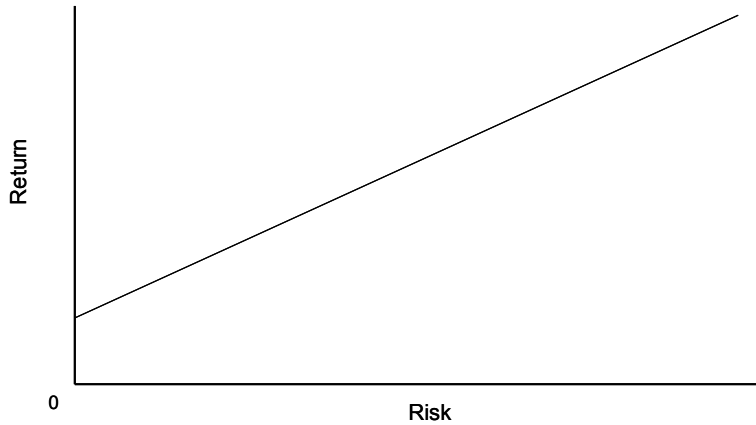
Why Does Risk Matter?

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.

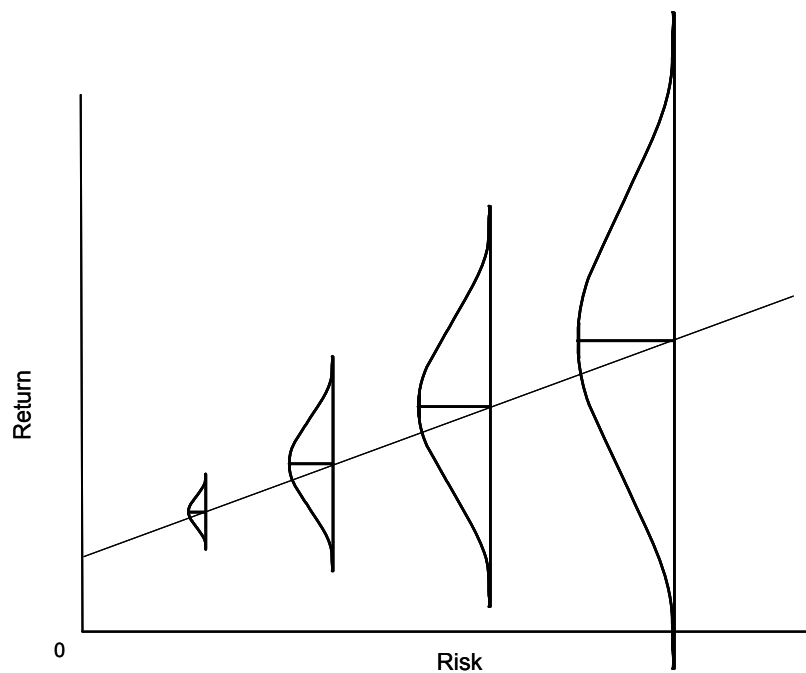
It is from the relationship between risk and return that arises the graphic representation that has become ubiquitous in the investment world. It shows a "capital market line" that slopes upward to the right, indicating the positive relationship between risk and return that is essential.



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

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Memo to: Oaktree Clients
From: Howard Marks
Re: It Is What It Is

My first exposure to the phrase that serves as the title for this memo came in 1995, a few days before Oaktree opened its doors. My partners and I wracked our brains over whether we'd covered every base. We asked our attorney, Peter Ostroff of Sidley & Austin, if he thought we'd missed anything. Peter's answer was succinct and on target as usual: "It is what it is."

In the March 5 edition of The New York Times, William Safire devoted the Sunday Magazine's "On Language" column to "it is what it is." He mentioned that the first use he could find had been in 1949, and that the phrase had been adopted for movie and song titles in the last few years. I was shocked when I checked Google and found 4.2 million references!

According to Safire, there is no one definitive meaning for the phrase. It can serve as the equivalent of the politician's "no comment." It can be used to express "philosophical resignation over a disappointment." Or it can be "a mild put-down, as if to say, 'That's all you can expect.'" Safire concluded his column with another possible meaning: "*que sera sera*" (what will be will be), which was the title of a hit song by Doris Day when I was ten. But that interpretation suggests a fatalism and inability to affect the outcome that I don't associate with the phrase.

I took Peter's use of the phrase in 1995 – and I'm using it in this memo – to mean something very different: recognition and acceptance of today's givens . . . but not necessarily of the end result. What's past is past and can't be undone. It has led to the circumstances we now face. **All we can do is recognize our circumstances for what they are and make the best decisions we can "given the givens."**

Roots in Philosophy

In the mid-'60s, Wharton students had to have a non-business minor, and I satisfied the requirement by taking five courses in Japanese studies. These surprised me by becoming the highlight of my college career and contributing to my investment philosophy in a major way.

Among the values prized in early Japanese culture was *mujo*. *Mujo* was defined classically for me as recognition of "the turning of the wheel of the law," implying acceptance of the inevitability of change, of rise and fall.

This sense of accepting and "going with" the environment and the changes that take place there – rather than insisting that it stay the same and attempting to impose our will on it – was captured for me in a quotation from Lao-Tzu (I found it in the March letter from Rimrock Capital, which Paul Westhead left Oaktree in 2004 to head):

To be strong you have to be like water: if there are no obstacles, it flows; if there is an obstacle, it stops; if a dam is broken, then it flows further; if a vessel is square, then it has a square form; if a vessel is round, then it has a round form; because it is so soft and flexible, it is the most necessary and the strongest thing.

In other words, *mujō* means cycles will rise and fall, things will come and go, and our environment will change in ways beyond our control. **Thus we must recognize, accept, cope and respond. Isn't that the essence of investing?**

Coping With Cycles

In the world of investing, (as you've heard me say many times) nothing is as dependable as cycles. Fundamentals, psychology, prices and returns will rise and fall, presenting opportunities to make mistakes or to profit from the mistakes of others. They are the givens.

We cannot know how far a trend will go, when it will turn, what will make it turn, or how far things will then go in the opposite direction. But I'm confident that every trend will stop sooner or later. Nothing goes on forever. Trees don't grow to the sky, and neither do many things go to zero and stay there. Success carries within itself the seeds of failure, and failure the seeds of success.

So what can we do about cycles? If we can't know in advance how and when the turns will occur, how can we cope? On this, I am dogmatic: **We may never know where we're going, but we'd better have a good idea where we are.** That is, even if we can't predict the timing and extent of cyclical fluctuations, it's essential that we strive to ascertain where we stand in cyclical terms and act accordingly.

What Can We Know, and How?

Even without knowing where we're going and when, we can deduce lots of valuable information about our investment environment.

First, where do we stand in the economic cycle? Is the economy several years into a recovery that may be due for a rest? Has it leveled out and begun to weaken? Or has it been weak enough long enough that we can reasonably expect recession to give way to recovery?

Second, how have the markets been performing? Have they been weak for years, possibly pushing prices to bargain basement levels? Or have they been so strong that we should suspect (1) the positives have been fully discounted, (2) several years of potential gains have been accelerated into the returns to date, and (3) assets today are "priced for perfection"?

Finally, and often most important, how are people around us behaving? If they're chastened by losses and afraid of the future, there's reason for us to be optimistic. If they're unworried and complacent, that's something we should worry about. In the words of my favorite Buffettism,

“The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.”

Imagine we ran into a visitor from Mars who observed, “I see your economy and markets have been doing well for years. Everyone’s making a ton of money. No one’s expressing worry or a desire to avoid risk. P/E ratios, buyout prices and private equity leverage ratios are all high. Stock buybacks and dividend recaps are adding to leverage and reducing creditworthiness. Conferences on hedge funds and private equity are sold out. Top-performing funds are closed to newcomers and new ones start up every day, fully subscribed. The Greenwich Ferrari dealer has a waiting list a year long.”

Nothing in our favorite Martian’s statements sounds like a prediction. **In fact, he hasn’t said one word about the future.** But there’s a lot of helpful information there. My guess is valuable inferences could be made about what’s likely to happen next. If he can see it, so should we. And having seen it, we should take appropriately cautious action.

And the reverse can also be true (although it’s not something I dwell on most of the time or at what I think is today’s point in the cycle). If that Martian came down and saw nothing but weak recent returns, widespread disillusionment, disinterest in investing and people waiting for the smoke to clear before they’ll commit, we’d probably conclude it’s time for us to step on the gas.

What to Do

There are few fields in which decisions as to strategies and tactics aren’t influenced by what we see in the environment. Our pressure on the gas pedal varies depending on whether the road is empty or crowded. The golfer’s choice of club depends on the wind. Our decision regarding outerwear certainly varies with the weather. Shouldn’t our investment actions be equally affected by the investing climate?

Most people strive to adjust their portfolios based on what they think lies ahead. At the same time, however, most people would admit forward visibility just isn’t that great. That’s why I make the case for responding to the current realities and their implications, as opposed to expecting the future to be made clear.

In November 2004 I wrote a memo entitled “Risk and Return Today.” Its thesis was that in most asset classes, prospective returns were low and risk premiums were skinny. On that basis, I urged investors to act accordingly, hold reasonable expectations and – especially – decline to stretch for higher returns by taking on more risk. The conclusions are just as clear today:

- When high returns are not in prospect, we shouldn’t invest as if they are.
- When safe investments appear unlikely to provide the returns we need, we shouldn’t rush to riskier investments to get them.
- This is especially true when the reward for taking incremental risk is skimpy.

It’s as simple as that. **We can’t expect high returns when the market doesn’t offer them. Prices won’t fall to levels from which high returns can be expected if most investors are**

willing to settle for less. To quote Peter Bernstein, “The market’s not a very accommodating machine; it won’t provide high returns just because you need them.”

My bottom line, as they might say in the self-help books: **Listen to your inner Martian.** What’s going on usually isn’t that big a mystery. An overheated environment doesn’t mean the market’s going down tomorrow, just as an excess of risk aversion doesn’t signal it’s the absolute bottom. But the circumstances should inform our behavior. Simply observing what’s going on around you and acting accordingly should improve your investment results.

And the distinctions needn’t be cut too fine. There can be lots of room for argument between “undervalued” and “fairly valued,” or between “fairly valued” and “overvalued” – that’s where most of the uncertainty lies. But it’s unlikely that disciplined investors will find it hard to choose between overvalued and undervalued. In my opinion, if you’re wracking your brain trying to figure out whether something’s overvalued or fairly valued – that is, whether you should sell or continue to hold – it’s usually pretty clear that it’s not a buy.

What Is Going On Around Us Today?

No one I know thinks investors today are acting out of an excess of caution, and I agree. Investors have forgotten the losses in stocks, corporate bonds and venture capital earlier this decade and consider this a low-risk world (or at least one where risk is clearly worth taking). Mark Cutis of Shinsei Bank sent me his memo entitled, “Market of no fear!” I think that’s an apt description.

There’s no reason to think today’s environment implies high future returns. Whether it’s high P/E ratios, high transaction multiples in buyouts, low bond yields or low capitalization rates on real estate (and certainly all of these are interrelated), few markets appear to offer bargains.

People are reporting big gains from private equity and real estate assets they bought cheap in the past, levered up in accommodating capital markets and sold at very high prices (read: low prospective returns). But fewer people can claim to be buying in on the cheap today.

A great deal of what’s happening is related to a glut of capital for investment in non-mainstream asset classes. With no one interested in buying more high grade bonds at yields near 5% or U.S. stocks with consensus expected returns of 5-7% or so, capital is bypassing those big markets – or perhaps exiting them – and flocking to the smaller alternative markets, raising prices. I understand why people who need 8% or more are looking there for help, but that doesn’t do much for the likelihood they’ll get what they’re after. (More on this later.)

The skinniness of today’s risk premiums can be observed most clearly in the high yield bond market, where prospective returns can be calculated with precision and yield spreads are in the vicinity of historic lows, and in certain real estate markets, where actual cash returns are similarly low. But the difficulty of quantifying prospective returns in public and private equity doesn’t mean the offerings there are any less paltry. And, as Alan Greenspan said, “. . . **history has not dealt kindly with the aftermath of protracted periods of low risk premiums.**”

This is a time for caution, not aggressiveness. For reaping more than sowing. I said it 16 and 34 months ago, and returns in many US markets have been paltry since. **Some alternative investment returns have been quite good, but high realized returns must never be confused with great opportunities to invest more.** High past returns don't imply high future returns; more likely, they've borrowed from the future.

The Poor Man's Guide to Market Assessment

Here's a simple exercise: I have listed below a number of market characteristics. For each pair, check off the one you think is most descriptive of today. And if you find that most of your checkmarks are in the left-hand column, as I do, hold on to your wallet.

Economy:	Vibrant	Sluggish
Outlook:	Positive	Negative
Lenders:	Eager	Reticent
Capital markets:	Loose	Tight
Capital:	Plentiful	Scarce
Terms:	Easy	Restrictive
Interest Rates:	Low	High
Spreads:	Narrow	Wide
Investors:	Optimistic	Pessimistic
	Sanguine	Distressed
	Eager to buy	Uninterested in buying
Asset owners:	Happy to hold	Rushing for the exits
Sellers:	Few	Many
Markets:	Crowded	Starved for attention
Funds:	Hard to gain entry	Open to anyone
	New ones daily	Only the best can raise money
	GPs hold the cards on terms	LPs have bargaining power
Recent performance:	Strong	Weak
Asset prices:	High	Low
Prospective returns:	Low	High
Risk:	High	Low
Popular qualities:	Aggressiveness	Caution and discipline
	Broad reach	Selectivity
The right qualities:	Caution and discipline	Aggressiveness
	Selectivity	Broad reach
Available mistakes:	Buying too much	Buying too little
	Paying up	Walking away
	Taking too much risk	Taking too little risk

An Inefficient Market in Investment Advice

Bruce Karsh and I recently had an opportunity to sit down to lunch with Charlie Munger. As usual, our conversation was most enjoyable, straying over a large number of topics. I think a few of them – plus some comments from Warren Buffett’s latest annual report – can be woven into something of relevance to this memo and of interest to you.

Bruce started off by observing that with practically everyone able to start up a billion dollar hedge fund, and with the leading private equity managers able to raise funds of \$10 to \$15 billion, jobs in those fields are in great demand as the way to get rich quick. It occurred to me that **if large numbers of people are convinced that a given field is sure to give them instant wealth, something must be wrong. That’s a “bubble expectation.”** Getting rich – if it can be accomplished at all – is supposed to come from some combination of proven skill, hard work, risk bearing and luck. No one should be able to count on it, and especially not in the short run. And given the operation of market forces, such an opportunity shouldn’t last long.

Then I remembered that for decades I’ve argued that exceptional risk-adjusted returns can only be achieved in inefficient markets, and even then not all the time or by everyone. And by “inefficient markets,” I’ve always meant markets where mistakes are being made. **So if large numbers of alternative investment managers and would-be managers are planning on getting rich quick, the investment management market must be inefficient: they and/or someone else must be making a mistake.** Who else could it be? **Maybe it’s their clients.**

Today, as everyone knows, funds can be raised easily and at sizes no one imagined just three years ago. But assets are no longer as cheap as they used to be, interest rates are no longer as low, and the economic recovery isn’t as young. I recently heard a speech in which a top buyout manager said his fund’s goal (per my memory) is to buy companies at fair prices and make them worth more. In the past, he might’ve said they tried to buy companies cheap.

On the plus side of the ledger for private equity, managers think more like owners than do many public company boards; are substantially incentivized to see the funds’ assets appreciate; and have the potential to improve their previously undermanaged companies. On the negative side, however, the three of us noted that clients are currently entrusting record amounts of money to these managers, along with management fees big enough to allow the managers to get rich without making successful investments, as well as a share in transaction fees that have the potential to put the interests of fund managers and their clients in conflict.

I believe the investors in these funds feel they’ll be happy if they can earn net returns in the very low double digits. The modest nature of their aspirations stems from the juxtaposition of (a) the perceived inadequacy (mentioned earlier) of the prospective returns on mainstream stocks and bonds, (b) the large sums some institutions have to invest, and (c) the 8%-or-better returns that pension funds and endowments must achieve if they are to continue business as usual. This combination makes it imperative that they commit to alternative investments and hedge funds, and thus tilts the balance of bargaining power over fees to the fund managers. This, in turn, decreases the likelihood that terms will be designed to maximize the clients’ interests. It also can give the managers amounts of capital that pose a problem.

In his letter discussing Berkshire Hathaway's 2005 performance, Warren Buffett tells the priceless story of the Gotrocks family, which owns all the corporations in America and earns all the profits. Over time, individual family members are approached by broker-Helpers, manager-Helpers and consultant-Helpers, who promise to help them make money (for a fee) by buying certain pieces of the empire from their relatives and selling them others. Eventually they also hook up with hyper-Helpers, wearing uniforms saying "Private Equity" and "Hedge Fund," who levy success fees on top of their other charges. It's clear that the collective efforts of all the Helpers in shuffling assets among Gotrocks family members are unlikely to increase the family's overall wealth (just as is true when companies are sold from one private equity fund to another). At the same time, whether they're successful or not, the costs involved in trying will cause a substantial transfer of wealth from the Gotrocks to their "Helpers." But that's the way it is.

In April 1998 I observed in "Views on Alternative Investments" that some good performing managers might choose to "appropriate for themselves a bigger portion of their funds' superior returns." This is natural and happens in all businesses where the product is in strong demand. But that doesn't mean buyers should ignore it when it occurs.

I'm not saying alternative investments and hedge funds won't provide the returns clients need, or that people shouldn't invest in them. But realistically assessing the demand for these funds, the amounts of money going into them, the market conditions for the underlying asset classes and the deals the managers are able to cut for themselves might cause would-be investors to conclude the silver bullet still hasn't been invented. **Participate in alternative investments if you want – in fact, Oaktree hopes you'll keep doing so – but do it with your eyes open.**

Charlie ended the lunch by urging us to create reasonable expectations among our clients and treat them well. We promised to try.

* * *

None of us can individually influence economic or market conditions. Neither, I think, can we accurately see what lies ahead. **But it's possible to derive inferences from the recent past and the present that improve our judgments and actions regarding the future. It's simply essential that we be aware of what's going on around us.** After all, who can argue with the statement "it is what it is"?

Facing up to reality is what Warren Buffett's doing when he says "We used to find it easy to buy dollars for fifty cents. Today we're trying hard to find dollars we can buy for eighty cents." (He also told me he has an 800 number for anyone who knows where 80-cent dollars can be found.) **Recognizing and accepting these things when they're true isn't pleasant, but there is no prudent alternative.**

Oaktree tries hard to take note of prevailing market conditions, communicate what's going on and behave as contrarians. We try to raise bigger funds and buy more aggressively when we think others are leaving bargains on the table and do the opposite when they're not. It doesn't always work, but it usually beats the alternative.

March 27, 2006

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Memo to: Oaktree Clients
From: Howard Marks
Re: Returns, Absolute Returns and Risk

What's In a Name?

My memos often touch on the subject of investors' foibles, one of the worst of which consists of their tendency to pay too much attention to labels (and too little to substance).

- Enthusiasm for “growth stock investing” carried investors to the ridiculous conclusion that for the stocks of the fastest-growing companies, no price is too high. That was just before the “nifty-fifty” stocks of America’s best companies lost up to 90% of their value in 1973-74.
- “Portfolio insurance” assured investors they could participate fully in stock market gains with protection against declines if they would simply commit to automatically enter sell orders pursuant to an algorithm. But in the crash of October 1987, investors found themselves unable to make those sales, and the ineffectiveness of the “insurance” (combined with the outsized positions it had encouraged) cost them dearly. And at any rate, portfolio insurance, like any mechanical risk-limiting device, should have been expected to limit long-term return as well as risk. After all, there rarely is a free lunch.
- “Market neutral” funds were supposed to be insensitive to market fluctuations, but the so-described Granite Fund of mortgage-backed securities melted down in just a few weeks when it turned out not to be insulated from the rapid rise of interest rates in 1994.
- “High yield bonds” drew people in, just as “junk bonds” had scared them away. One of my favorites was the mutual fund investor who said in 1990, “I thought it was a high yield bond fund; I never would have invested if I’d known it was a junk bond fund.”
- “Gonna change the world” is what people believed about e-commerce and the Internet. A few of the companies did, as had pioneers in radio and airlines. However, “change the world” proved once again to be far from synonymous with “make money for investors.”
- Today, of course, almost everyone wants to invest in “hedge funds” . . . even though almost nobody can define them. In 2005, the average returns for the best and worst performing hedge fund categories were 17.4% and -2.6%. Clearly, then, the term “hedge fund” cannot be much help in the selection of investment vehicles. Economist Brad Setser was quoted in The Wall Street Journal of May 31 as posing and answering his own question: “I thought hedge funds were supposed to be hedged. I fully realize . . . that in many ways the name ‘hedge fund’ doesn’t tell you much about what a fund does.”

The bottom line is that, in the world of investing, words mean almost nothing. All that matters is what you're buying, the price you're paying for it, and the risk that it will fail to deliver all you expect. No weight should be attached to what something's called, as labels alone have little significance with regard to risk and return.

Asset Class Returns

Importantly in this connection, I continue to insist that no asset class and no investment technique possesses a natural or embedded rate of return. Fixed income comes closest, with its promise of interest and the repayment of principal. But for the holder of a 20-year bond, most of the total return over its lifetime will come from “interest on interest” – the interest that is earned on interest payments that have been received – and this will vary with rates. Thus, even in fixed income instruments (other than zero-coupon bonds), the return is far from intrinsic.

And from there, the connection between an asset class label and a prospective rate of return grows more and more tenuous. What's the return on S&P 500 stocks? If you had asked 100 institutional investors and consultants in 1999, virtually all of them would have said 9-11%. Ask them today and they're likely to say 5-7%. What changed? Not the asset class itself, but opinions surrounding it. Obviously, meanings ascribed to words alone often fail to hold up.

For a final example, what about the asset-class return on private equity? This strikes me as an even more unreliable concept. The return on a private equity investment will come from the combination of (a) the potential of the underlying company and (b) the ability of the manager to identify the opportunity, buy the company at a good price, make it a better company, and sell it at higher valuation parameters than it was bought for. Certainly all of the elements included in “b” are highly dependent on the manager's skill and have little or nothing to do with the fact that the investment belongs to a given asset class.

Absolute-Return Investing

My memos are often sparked by something I stumble on, and this one is no exception. The prompt came from “The Myth of the Absolute-Return Investor” by M. Barton Waring and Laurence B. Siegel (*Financial Analysts Journal*, March/April 2006).

Many people talk today about absolute-return investing and say they want to put money with absolute-return funds and managers. But as Waring and Siegel indicate, there's no broad agreement on what that means. They start their article by citing a few popular definitions for absolute-return investments, which seem to be distillable to **investments possessing the potential for positive returns regardless of general market conditions.**

In my opinion, if you're interested in absolute return investing, you should be looking for a steady outcome rather than responsiveness to market conditions. In this context, I tend to think of “absolute” along the lines suggested by one of the many definitions in Webster's Dictionary: **“free of external references or relationships.”**

When one of the investment committees I'm on decided to increase the portfolio's commitment to "absolute-return hedge funds" several years ago, the general consensus was that we wanted funds that would reliably deliver 9-10% or so. We wouldn't expect to do much worse regardless of how badly the markets performed, and we wouldn't be surprised if we failed to do much better when the markets rose. In other words: **a steady, healthy return (implying good relative performance in bad times), but consequently with the likelihood of lagging the markets when they do well.** Raise your hand if you agree.

But problems arise. Most hedge funds do better in good years than bad, implying that they're not really insensitive to market developments. Most hedge fund managers would acknowledge that their returns are derived from a combination of beta and alpha (that is, from market return plus the skill they bring to the investment process). And as long as beta plays a meaningful part, an investment's return can't really be described as "absolute."

Waring and Siegel argue that there's no such thing as absolute investing, in that the alpha it aims to capture arises from relative decisions that are the basis for all active management. By this they mean that active management consists of trying to overweight (in relative terms) the things in a benchmark or market that will do better and underweight the things that will do worse, and by having more exposure to the benchmark or market in good times and less in bad times. These, they argue, are relative investing decisions.

No wonder we could not sensibly define absolute-return investing: There is no such thing. The term is intended to capture investor attention by offering an intuitively appealing alternative to the disciplines required by relative-return investing, but at the end of the day it delivers beta returns plus or minus relative (alpha) returns . . . It may appear to be a distinct type of investing, but if there is a distinction, it is a distinction without a difference.

I think Waring and Siegel go too far, and some of this feels like wordplay. You can call trying to buy the good and avoid the bad "relative investing," because the decisions are made relative to the makeup of a market or benchmark. And it's true, as Sid Cottle (of Graham, Dodd and Cottle) put it to me thirty years ago, that "investment is the discipline of relative selection." But "relative" is just a word. The quest for better portfolios doesn't necessarily make all active investors "relative investors" in the index-centric sense of the term.

Waring and Siegel insist "the notion that every return has a beta component and an alpha component applies to any portfolio." And as they describe Bill Sharpe as saying, "The return on *any*, repeat *any*, portfolio consists of a market part and a nonmarket part." However, there are investors and funds whose goal it is to buy the good and avoid the bad and, at the same time, to minimize the effect of general market fluctuations on their returns. They want to bring that beta term as close as possible to zero, and some are able to pull it off – more or less.

So I think "absolute return" is a relative term, not – pardon me – an absolute one. But it's still potentially useful. **To me absolute-return investing means – perhaps stating the same thing a few different ways – that (a) the contribution to return from alpha should be visibly more pronounced than from beta, (b) the return should be significantly steadier than that of the**

market, and (c) there should be a relatively low correlation between the fund’s return and the relevant market returns. We just shouldn’t expect the correlation to be zero.

Hedge Fund = Absolute Return = Market Neutral?

Are hedge funds absolute return vehicles? According to the article that inspired this memo, “Today, the term ‘absolute return’ seems to be used most often to describe what wealthy individual investors have always called hedge funds.” I do hear a lot of people use the terms somewhat interchangeably. For that reason, I’d like to spend a few paragraphs exploring just how “absolute” hedge fund returns really are, with data from Credit Suisse/Tremont.

Here are the average returns on three hedge fund categories:

	<u>Credit Suisse/Tremont Hedge Fund Index</u>		
(total return in %)	<u>Overall Average</u>	<u>Equity Mkt Neutral</u>	<u>Long/Short Equity</u>
1994-2005	10.7%	9.9%	11.9%

Certainly these funds satisfied the 9-10% goal expressed above for absolute returns . . . or did they? A couple of years ago, I had some fun asking how often the annual return on the S&P 500 had fallen within what was then thought to be the “normal” 8-12% range. Now let’s do the same for hedge funds: in how many of the last twelve years was the average return on these three hedge fund indices between 8% and 12%? The answer for each index: just once or twice.

Take the “market neutral” sector. Its average return, at 9.9%, was square in the desired range, and its annual returns were the least variable of the three hedge fund sectors, as one would expect. But was it really market neutral? In the period 1995-2000, the average market neutral fund returned 14.3%, with yearly returns ranging from 11.0% to 15.3%. In the slower period 2001-05, the average fund returned 7.3%, with yearly returns ranging between 6.1% and 9.3%. The annual returns within each sub-period were quite steady despite the market’s fluctuations (and never negative, which was quite an accomplishment). But certainly the average varied greatly from period to period, and it fell between 8% and 12% only twice in those twelve years. Even the relationship that these funds’ returns are supposed to bear to Treasury bill returns (e.g., “T-plus-500”) seems to have been achieved on average but not with consistency. Bottom line: the returns on “market neutral” hedge funds are not immune to external developments.

Moving from market neutral funds to equity long-short funds and hedge funds in general, the table below shows returns for two pairs of back-to-back years in which the stock market boomed and busted.

(total return %)	<u>Up-and-down</u>		<u>Down-and-up</u>	
	<u>1999</u>	<u>2000</u>	<u>2002</u>	<u>2003</u>
Hedge Fund Average	23.4%	4.8%	3.0%	15.4%
Long/Short Equity Avg	47.2	2.1	-1.6	17.3
S&P 500	21.0	-9.1	-22.1	28.7

Investors were glad to be in these funds rather than the S&P 500, as the returns were much steadier for the hedge funds than for the market and higher overall. But does the fact that losses were minimized or avoided in the down years mean that hedge funds provide absolute returns? That depends on your criteria for “absolute.” If “insensitive to market movements” or “free of external references or relationships” are among them, they do not meet the standard.

According to The New Yorker of May 22, 2006, “A recent paper by the economists Burton Malkiel and Atanu Saha . . . showed that the range of performance among hedge-fund managers was much wider than among mutual-fund managers . . .” And Dow Jones estimates that the average equity long/short hedge fund lost 5% last month. So not consistent from fund to fund, and not consistent over time. Finally, research has shown that significant beta exposure is embedded in many hedge funds. In the spring 2004 Canadian Investment Review, Dominic Clermont of TD Asset Management reported the following findings:

Over the 1994-2000 period, the aggregate hedge fund index had a market exposure (beta) of 0.37. Thus, on average, a significant portion of hedge fund managers’ returns came from market exposure. Some hedge fund strategies, such as emerging market hedge funds, had a much higher beta of 0.74.

These observations certainly call into question the absoluteness of hedge fund performance.

What Do Investors Want?

That’s a trick question, because the answer is usually heavily reliant on investors’ recent experience. When market performance has been good, they want participation going forward. But when performance has been bad, they demand protection.

An endowment portfolio that delivered 15% per year in the late 1990s was described as disappointing, because many others made 20%-plus. But a portfolio that made 2% in the first few years of this decade was lauded, because most lost money. So people can feel good about 2% and bad about 15%. That’s human nature for you (and it shows why things other than absolute return matter . . . and perhaps why “common sense” is such an oxymoron).

It also shows how danger creeps into markets. When everything’s been going swimmingly, investors forget about risk and want a full ride on the bandwagon. Seldom do they express concern about the fact that good past performance implies elevated asset prices, and maybe low returns and high risk going forward. By the same token, on the heels of market losses, investors

tend to pull in their horns and opt for safety – even though the best buying opportunities usually grow out of market dislocations. In this regard, short-term hindsight is worse than no help – it’s a hindrance. And it’s what makes contrarian investing effective.

Investors don’t want the same thing at all times, fluctuating in their appetites as they do. This tells me they won’t always be satisfied with so-called absolute returns, even if they can be achieved.

Maybe they just want it all. In an old commercial, the multi-talented Deion Sanders was asked “Which would you rather play, baseball or football?” and he’d say “Both.” “Offense or defense?” “Both.” When I ask would-be investors whether they want upside potential or downside protection, they often answer “Both” . . . only half kidding, I think.

What Should Investors Want?

Of course, I think investors should pursue superior risk-adjusted performance. The goal of many investors – higher highs and higher lows – just isn’t practical. If you emphasize offense, you’re likely to see higher highs and lower lows. And if you choose defense, you should get higher lows but also lower highs. It takes a lot of skill to produce anything else.

The quest for what I think most people mean by absolute investing – decent highs and lows that aren’t low – is not unreasonable. But I still think (a) delivering that kind of performance requires a lot of skill, (b) most investors can’t do it, and (c) the ones who can won’t be found by picking funds according to their labels, but as a result of a thorough and difficult study of managers and their abilities.

At Oaktree, we constantly tell people the following:

- **In good times, it’s good enough to be average.** At first glance, that seems like a heretical and far-too-modest goal. But during good times, the average investor makes a lot of money; why shouldn’t “average” be good enough?
- While above average returns are always nice, why would anyone put an emphasis on beating the market when the market does well? What makes it worth taking the higher risk – and holding the idiosyncratic portfolio – that’s required for outperformance in a rising market?
- On the contrary, in a rising market, mere participation should be good enough; out-performance seems superfluous.
- **There is a time when it’s essential that we outperform, and that’s in falling markets.** Our clients don’t want to bear the full brunt of a market decline, and neither do we.
- In order for outperformance in bad markets to be achieved, a portfolio has to carry so much downside protection that it can render outperformance on the upside hard to achieve. It would be nice to be able to do both, but it’s challenging.
- **If we can just accomplish these two goals – market performance (or a bit better) in good times and highly superior performance in bad times – we’ll end up with above average performance over full cycles; below average volatility; outperformance in tough times (when it really matters); enough resolve to be able to resist selling out at cyclical lows; and a favorable investing experience overall.**

These goals may seem modest at first glance, but few investors have been capable of meeting them for periods spanning multiple decades. They're the goals we've set for ourselves, and we're proud to have reached them thus far.

The Role of Risk Management

The key to achieving superior returns in bad times (and especially to doing so without stripping a portfolio of its potential to make money in good times) is found in the ability to control risk. It's not a matter of finding winners, but of building a portfolio where upside potential is accompanied by downside protection – no mean feat.

In the investment world, we hear a lot more about achieving returns than we do about controlling risk. But as you explore the higher reaches of the profession – as you move into the hedge fund world, for example – the latter grows in importance. Ultimately, the key is to be able to manage risk well enough that upside can be attempted without commensurate exposure to downside.

The subject of risk control – and, especially, the process of assessing who does it well – is extremely thorny. When I wrote the memo “Risk” in February, I thought I had hit on something when I observed that risk is not measurable even after the fact. Now I want to take that thought a little further.

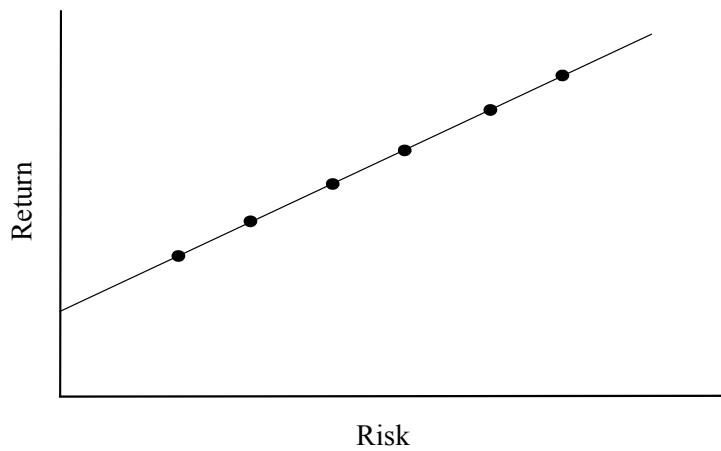
Defining “A Good Job”

There are reasons why the headlines each year go to the person who achieved the highest return, not the person who best managed risk. The first is that people care more about return and are more titillated by it. But the second is that it can be far from obvious who did the best job of risk management. Different investors can define investment risk differently, but if it isn't the same as inter-month or inter-year volatility – and I'm convinced it's not – then it can't be easily observed and quantified. This is especially true in good years, when risk remains invisible.

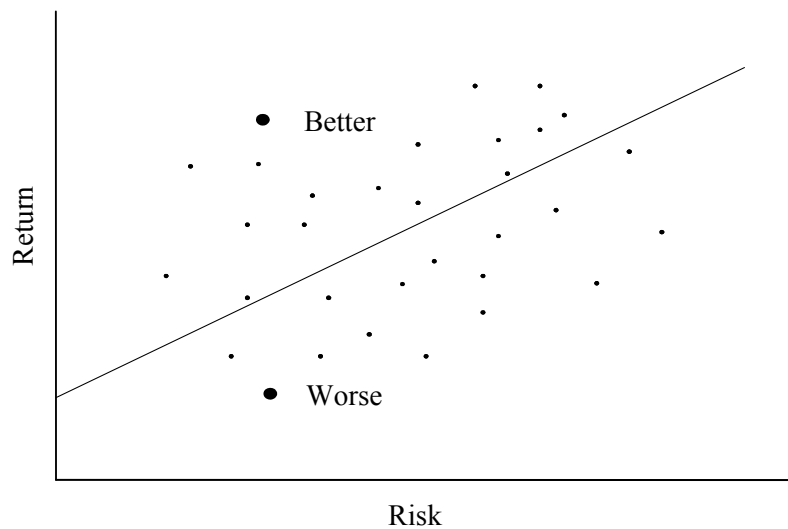
One portfolio manager makes 10% and another makes 15%. Who did the better job? When I attended the University of Chicago in 1967, I was taught that in order to decide how well a portfolio had performed, you have to assess how much return was achieved and how much risk was borne. That still makes sense to me. How much risk did a manager take? Which manager's risk-adjusted return is higher? It can be hard to judge these things, but investors shouldn't wait for a down year to attempt an answer.

Modern portfolio theory and the efficient market hypothesis define risk as volatility and tell us that markets price assets so they'll offer returns that are proportional to their risk, no more and no less. For this reason, they say, superior risk-adjusted returns cannot be achieved. The beauty of inefficient markets – to the extent they exist – lies in the belief that this rule need not hold: that you can get more return than is justified by the risk.

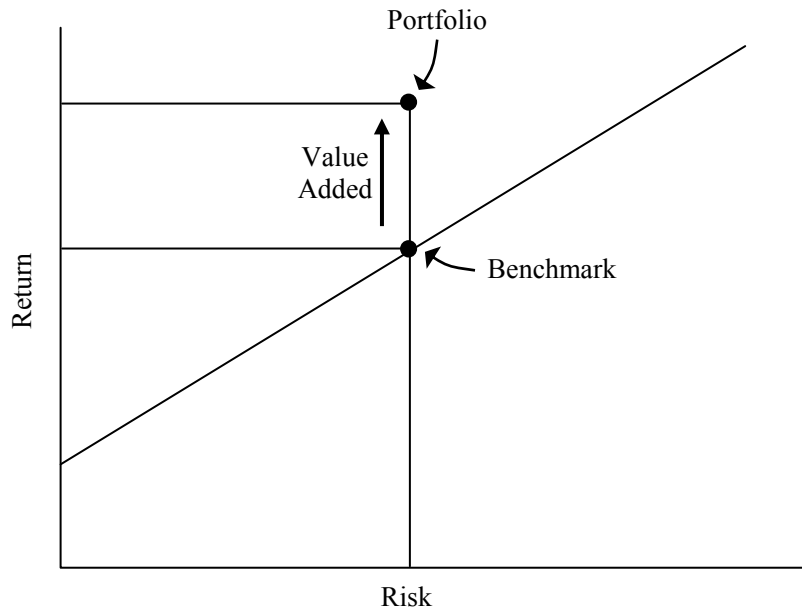
In efficient markets, all assets line up so that there's a fixed relationship between return and risk, with no outliers. Risk and return are linked, and investors' results invariably fall along the line.



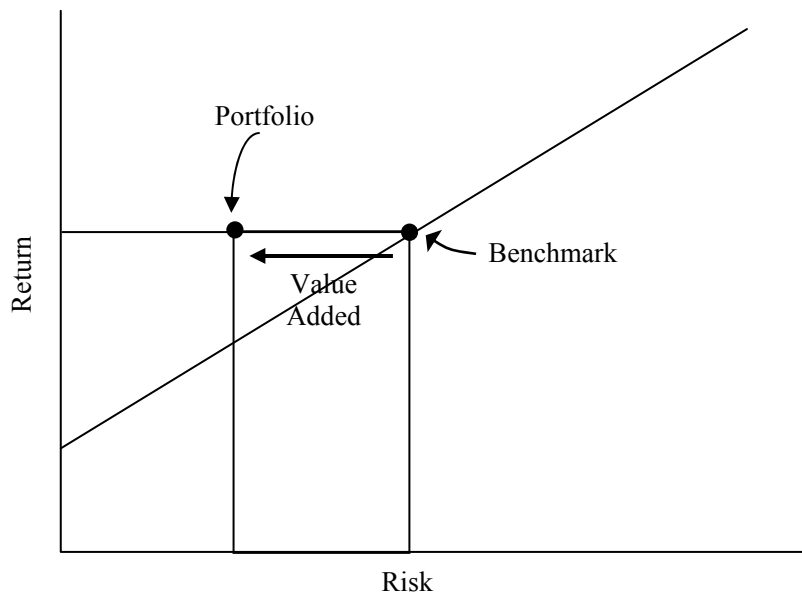
In inefficient markets, mistakes are made, such that risk and return need not be strictly proportional. Some investment merit is overrated, and some opportunities are overlooked. As a result, it becomes possible to achieve superior and inferior risk-adjusted returns.



Not everyone quite understands this point, but I feel even those who do often fail to appreciate all of the implications. Most observers think the advantage of inefficient markets lies in the fact that a manager can take the same risk as a benchmark, for example, and earn a superior rate of return. The following graph presents this idea and depicts the manager's "alpha," or value added through skill.



This manager has done a good job, but I think this is only half the story – and for me the uninteresting half. **An inefficient market can also offer the ability to achieve the same return as the benchmark while taking less risk, and I think this is a great accomplishment. It provides the foundation for achieving the performance goals enumerated on page 6.**



Here the manager's value added comes not through higher return at a given risk, but through reduced risk at a given return. This, too, is a good job – maybe even a better one.

Some of this is semantic and depends on how you look at the graphs. But because I think fundamental risk reduction can provide the foundation for an extremely successful investing experience, this concept should receive more attention than it does. **How do you enjoy the full gain in up markets while simultaneously being positioned to achieve superior performance in down markets? By capturing the up-market gain while bearing below-market risk.**

The “best investor” profiled by the media each year is usually the one with the highest return. Risk control is rarely lauded, in part because it’s often invisible. But that doesn’t mean it’s unimportant. **Most of the investing careers that produce the best records are notable at least as much for the absence of losses and losing years as they are for spectacular gains.** The challenge is that these virtues usually become apparent only in big downdrafts. But certainly they figure greatly in the long term.

Portable Alpha

Along with absolute-return investing and hedge funds, “portable alpha” is another big deal today. It’s often offered up as the next “silver bullet” – a surefire way for investors to achieve their goals without fear of disappointment. So I want to give you my take on this phenomenon – making clear, as usual, that I’m a mere observer, not an expert.

Portable alpha proposes the following: Suppose, for example, you want to invest \$100 million in mainstream stocks, and you also want alpha, leading to superior risk-adjusted returns. The problem is that, traditionally, investors wanting to invest in a given asset class have been restricted in their search for alpha to managers operating in that class. But if you acknowledge that alpha is hard to achieve in mainstream stocks given the high degree of market efficiency, you can use portable alpha to “transport alpha” earned in any other asset class to the portion of your portfolio allocated to mainstream stocks.

So you give up on finding your alpha in the mainstream stock market and pursue it by assembling a “value-added” portfolio of funds run by highly skilled managers in a wide variety of markets – probably in alternative investing fields such as hedge funds, private equity, commodities, etc., and probably not in mainstream stocks. Then you assess how much market exposure is embedded in the value-added funds and, using derivatives such as futures, swaps and options, you add market exposure until the beta of the total portfolio equals the beta of \$100 million of stocks. In this example, the market exposure implicit in the derivatives plus the funds gives you the return on a \$100 million passive portfolio of stocks, and the skillful management of the funds gives you their managers’ value added. The sum of the two achieves your goal: a \$100 million position in stocks with alpha.

Any time Wall Street packages existing elements to produce a surefire solution, my first thought is “alchemy!” I don’t want to be accused of neophobia – fear of anything new – but I also doubt that sure things come along very often.

Do I believe that over time a combination of derivatives plus hedge funds can outperform the same sum invested with traditional managers? Absolutely . . . but not necessarily for the reason advanced by the advocates. And that brings me back to the subject of absolute return.

Value-added funds that generate alpha clearly are an essential ingredient if portable alpha is going to work. Many managers claim the ability to generate alpha based on their skill, experience and access to alpha-generating strategies. But only the best will prove able to accomplish the difficult task of obtaining true alpha, after returns have been adjusted to recognize embedded beta bets. Thus real alpha may not always be responsible for portable alpha's contribution.

In my opinion, a more common reason for a portable alpha portfolio to deliver higher returns over time may be that it entails leverage. Because the value-added funds may not be as "market neutral" or "absolute return" as is thought – and because portable alpha managers may fail to properly adjust for embedded betas – the market exposure delivered by the total portfolio can end up being more than would be entailed in its benchmark (e.g., a traditional long-only stock portfolio). In that case, the portable alpha portfolio will represent a leveraged position. (That is, the sum of the beta on the derivatives plus the beta on the funds may exceed the beta of a traditional stock portfolio.)

If that's true, the portable alpha portfolio should provide higher returns in up markets than the traditional portfolio. This will be so as long as traditional managers' alphas aren't sufficient to offset both the leverage and the value-added fund managers' alphas (which everyone assumes is out of the question given today's belief in alternative funds and disrespect for traditional investing). **But the portable alpha portfolio may lose more in down markets unless the value-added fund managers' alpha exceeds the traditional managers' alpha by enough to offset the increased losses that can stem from a portable alpha portfolio's leveraged market exposure.**

Now then, if pension funds or endowments aren't permitted to borrow to achieve leverage and want to increase market exposure this way, I say "have at it." But they should call it what it is, rather than insist that they're combining 2 plus 2 and getting 5.

And remember that even after a portable alpha program has been in place for a period of years and produced results ahead of its benchmarks, it may not be possible to accurately assess whether the advantage came from the skill of the value-added managers, the effectiveness of the portable alpha approach, or leveraged market exposure. Because risk often is truly invisible, you can't always tell how much market risk you bore, and thus whether the key was really alpha or beta.

Portable alpha has the potential to improve results – in good markets and generally over time (since markets usually go up). But it won't do so in all markets – or do so on a risk-adjusted basis – unless the person given the job of structuring the portable alpha portfolio can (a) identify and access value-added funds that truly are capable of generating alpha, (b) accurately gauge their embedded risk, and (c) properly structure the overall portfolio.

Outstanding managers may be able to satisfy the criteria for success enumerated just above, but that doesn't mean they'll do it all the time. And there's no assurance that less capable managers will do it even on average. **So, once again, the mere term "portable alpha" doesn't hold the key to success. Success will only be found in execution of the concept by managers**

possessing rare skill. To think every would-be purveyor of portable alpha will be able to do it consistently is, like so many other things in my investment experience, too good to be true. Without great execution, “portable alpha” is just one more seductive label.

* * *

No market is entirely efficient and none is entirely inefficient. It’s all a matter of degree. In the same way, few if any funds are entirely market neutral, and even those that aim for absolute returns will demonstrate considerable susceptibility to market fluctuations.

A lot depends on your preference for offense (which usually leads investors to non-hedged or non-absolute investing) versus defense (for which managers emphasizing risk control – like some hedge funds – may be best suited). In the long run, it comes down to identifying managers who employ the style of investing that appeals to you and are capable of living up to your expectations. Not that complicated, but far from easy.

June 13, 2006

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Memo to: Oaktree Clients
From: Howard Marks
Re: You Can't Eat IRR

Until rather recently – certainly up to the early 1980s – “investing” was largely synonymous with “stocks and bonds.” And the performance of a stock or bond portfolio was evaluated in terms of its rate of return. You invested a certain amount of capital, and the percentage by which it increased in a given year was its annual return. To quantify performance over a multi-year period, you chained the individual yearly returns to come up with a compound annual return:

	<u>Annual Return</u>	<u>Dollar Gain</u>	<u>Portfolio Value</u>
Initial Investment			\$1,000
Year 1	10%	\$100	1,100
Year 2	15	165	1,265
Year 3	8	101	1,366
Comp. Ann. Return	11%		

But in the last few decades, buyout and venture capital funds came along, changing things. Funds like these start with capital commitments, call and invest their capital over time, and thereafter manage and liquidate their portfolios. They expand and contract radically, and in assessing their performance, it's clear that a given year's percentage return matters more – and thus should be given more weight – if it was achieved when the fund held a lot of capital (and less if it was not).

Investors wisely concluded that the performance of such funds should be assessed using a measure capable of capturing this phenomenon. They turned to “internal rate of return,” the now-ubiquitous “IRR,” as the yardstick with which to measure results for portfolios that experience significant cash inflows and outflows.

In mathematical terms, IRR is the discount rate that sets a fund's cash outflows equal to its inflows in present value terms. In other words, you list all of the fund's contributions and distributions and solve for the discount rate that makes them add up to zero. If discounting at 20% accomplishes this, then the amounts received in distributions represent an average advance of 20% per year over the capital contributed, and that's the fund's IRR.

I'll provide a simple example on the next page to illustrate the difference that can arise between compound annual return and IRR.

Fund A	<u>Annual Return</u>	<u>Dollar Gain</u>	<u>Distribution</u>	<u>Portfolio Value</u>
Initial Investment				\$1,000
Year 1	10%	\$100	\$600	500
Year 2	40	200	650	50
Year 3	100	50	100	--
Comp. Ann. Return	45%			
IRR	21			

The 10% gain in year one, achieved on starting capital of \$1,000, produced a \$100 gain in the fund's value. The 100% return in year three, on the other hand, was applied to just \$50 of capital, producing a gain of \$50. Although the percentage return was much higher in year three, it produced just half the dollar gain as the smaller return in year one. Thus, in calculating the fund's overall performance, the 100% return should be accorded much less weight than the 10% return. IRR produces that result (whereas compound annual return does not).

Because a given year's annual result is weighted in the IRR calculation by the number of dollars in the fund that year, and thus counts for more when the fund is larger and less when it's smaller, internal rate of return is referred to as a "dollar-weighted" return. To make the distinction clear, the old compound annual return is now referred to as a "time-weighted" return. This nonsensical term means that every year's individual return is given the same weight in the calculation. It's the same as saying "equal-weighted," or even "unweighted" . . . but "time-weighted" sounds much more scientific. (It's not for nothing that George Bernard Shaw defined professions as "conspiracies against the laity.")

For Fund A, shown above, the three-year IRR is 21%. This is far more reflective of the amount of wealth created than is the 45% time-weighted return. The difference arises because the IRR calculation gives relatively little weight to the 100% return achieved in the third year, whereas the time-weighted return gives it as much weight as the first-year gain of 10%.

To fully understand the importance of this distinction, consider Fund B, which achieves the same annual returns as Fund A – and thus the same compound annual return – but holds on to all of its capital through the end of the third year.

Fund B	<u>Annual Return</u>	<u>Dollar Gain</u>	<u>Distribution</u>	<u>Portfolio Value</u>
Initial Investment				\$1,000
Year 1	10%	\$ 100	0	1,100
Year 2	40	440	0	1,540
Year 3	100	1,540	\$3,080	--
Comp. Ann. Return	45%			
IRR	45			

The annual returns are the same for Fund B as for Fund A (and thus so is the three-year compound annual return). But Fund B's IRR is 45% (the same as its compound annual return, since there weren't any interim inflows or outflows), while Fund A's is 21%. The difference arises because Fund B achieved its 100% return in year three with beginning capital of \$1,540, as compared with just \$50 for Fund A. Fund B produced total distributions of \$3,080, while Fund A's distributions totaled only \$1,350. Certainly Fund B's performance should be considered superior – even though the two funds' time-weighted returns are the same. Fund B's superiority is captured by its higher IRR.

Big Percentage Gains on Small Dollars – Real-Life Example #1

I would find it hard to invent examples as extreme as some of those provided by real life. Let's look at the results for our first distressed debt fund – Special Credits Fund I – in 1996, its last year in business.

This fund was formed in October 1988 with committed capital of \$96.5 million, which was fully drawn and invested by the end of 1990. It achieved annual before-fee returns ranging between 29% and 89% in 1991-94 and made large distributions in 1992-93. By the end of 1995, its since-inception time-weighted return had reached 23.7%, its IRR stood at 24.0%, and it was down to one asset carried on the books at \$1.9 million. So far, a simple picture.

In the first few weeks of 1996, that sole remaining asset was sold for more than \$10 million. On the strength of that sale, the fund reported a 579.1% annual return for 1996. This high annual return (and the very brief period of time it took to achieve it) had the effect of doubling the fund's time-weighted return from 23.7% at the end of 1995 to 46.9% in 1996.

And yet, the \$8 million profit realized on the sale of that last asset added just 8% to the fund's total dollar gain, bringing it to \$104 million. Properly, the effect on the fund's cumulative IRR of this small-dollar, high-percentage gain was limited to lifting it just from 24.0% at the beginning of 1996 to 25.5% at the end. It goes without saying that, if relied on, the time-weighted return of 46.9% would have presented a highly distorted picture of this fund's achievements. IRR is much better than time-weighted returns because it isn't fooled by high percentage returns achieved with little capital invested.

Time-weighted returns are irrelevant for evaluating the performance of private equity-type funds. IRR is the answer. Or is it?

IRR's Limitations

The good news is that internal rate of return is infinitely better than time-weighted return as a tool with which to evaluate the performance of funds that expand and contract. The bad news is that IRR is far from perfect, far from sufficient, and relied on far too much.

Most of IRR's shortcomings surround the very phenomena it is designed to capture: inflows and outflows. Because private equity funds can expand and contract at widely varying rates, IRR can't tell the whole story. **IRR shows how good a job the manager did with the capital he**

employed. But it doesn't tell you anything, for example, about how promptly he put the capital to work.

Here are the results for two funds, both of which have committed capital of \$1,000:

Year	Fund X					Fund Y				
	Capital Call Jan. 1	Invested Capital Jan. 1	Annual Return (%)	Dollar Gain	12/31 Value	Capital Call Jan. 1	Invested Capital Jan. 1	Annual Return (%)	Dollar Gain	12/31 Value
1	\$100	\$ 100	10%	\$ 10	\$ 110	\$10	\$ 10	10%	\$ 1	\$ 11
2	200	310	20	62	372	20	31	20	6	37
3	300	672	30	202	874	30	67	30	20	87
4	400	1,274	40	510	1,784	40	127	40	51	178
				\$784					\$78	
IRR					31%					31%

Because they both made capital calls at the same time and in the same proportions, and they both achieved the same annual returns on their invested capital, Fund X and Fund Y show the same IRR. But Fund X racked up dollar gains totaling \$784 on its \$1,000 capital commitment, while Fund Y's gains totaled just \$78. Even though they had the same IRR, no one would say they performed equally well. Fund X called down all of its capital and invested it profitably, while Fund Y called down and invested only a tenth of its capital. The process through which IRRs are calculated is oblivious to that important difference, since its only inputs are fund contributions and distributions.

The manager of Fund X got the money to work much faster than Fund Y and produced \$704 more of gains on the same \$1,000 capital commitment. **If two funds can produce the same IRR but such different total profits, IRR simply can't be a perfect yardstick. Clearly, the ability of a manager to put capital to work both profitably and promptly has to matter.**

How about funds X and Z? (The data is the same as in the table above, other than the fact that each of Fund Z's annual returns has been increased by ten percentage points versus Fund Y.)

Year	Fund X					Fund Z				
	Capital Call Jan. 1	Invested Capital Jan. 1	Annual Return (%)	Dollar Gain	12/31 Value	Capital Call Jan. 1	Invested Capital Jan. 1	Annual Return (%)	Dollar Gain	12/31 Value
1	\$100	\$ 100	10%	\$ 10	\$ 110	\$10	\$ 10	20%	\$ 2	\$ 12
2	200	310	20	62	372	20	32	30	10	42
3	300	672	30	202	874	30	72	40	29	101
4	400	1,274	40	510	1,784	40	141	50	70	211
				\$784					\$111	
IRR					31%					41%

Now Fund Z's IRR isn't the same as Fund X's – it's higher. But Fund Z produced dollar gains totaling just \$111, while Fund X's gains total \$782. Fund X – with the lower IRR – has to have done the better job. **Again, evaluation based solely on IRR proves clearly inadequate.**

The Answer (Maybe): Times-Capital-Returned

Because of the shortcomings of IRR – primarily the fact that it tells you what the return was on the capital employed but not how much capital was actually employed – people seeking to measure fund performance have come up with an alternative measurement: times-capital-returned, or TCR (that's my name for it; there are lots of others).

Whereas the calculation of IRR is complicated, for TCR it's simple: How much did you commit to the fund, and how much did it return? If you commit \$1 million to a fund and receive distributions totaling \$2 million over its life, its times-capital-returned is 2.

TCR solves IRR's problem with undrawn capital. Looking at the table on page 4, Fund X's TCR is 1.78 (ending value of \$1,784 divided by committed capital of \$1,000), and Fund Y's TCR is 1.08 (\$1,078 – the total of the ending value of \$178 and the uncalled capital of \$900 – divided by committed capital of \$1,000). The difference between the two TCR ratios reflects the fact that even though the two funds earned the same return on the money they managed to invest, Fund X did a far better job of putting its capital to work.

Before proceeding, it's important to note that there is considerable unevenness in the way profitability ratios are calculated. Some people don't look at the ratio of ending value to committed capital, but rather at the ratio of ending value to contributed capital or invested cost, sometimes called a "multiple of cost." **I consider this highly inappropriate, as it tells you how much was earned on the capital that was invested but does not deal at all with the fact that capital went undrawn (and as such it shares IRR's great shortcoming).** Certainly managers should be held responsible if they fail to promptly invest the capital commitments they accept. Multiples based on investment rather than commitment don't accomplish this.

Let's calculate the multiple of cost – the ratio of ending value to contributed capital – to the data for Funds X and Y shown on page 4. Fund X's ratio is 1.78 (\$1,784 divided by \$1,000). So is Fund Y's (\$178 divided by \$100). But who doesn't think Fund X did the better job?

As opposed to a fund that calls down 10% of its committed capital and achieves a high IRR and multiple of cost, a limited partner would probably prefer a fund that draws down all of its capital and earns even a somewhat lower IRR and multiple of cost. Of course, this ultimately depends on how the limited partner feels about having capital uncalled, and on what he does with it while it is uncalled.

Times-capital-returned (in which committed capital is the divisor) is much better than IRR in that it takes into consideration both how much of the committed capital was called and the return that was earned on it.

Unfortunately, times-capital-returned isn't perfect either. Simply by holding on to its capital long enough, a low-return fund can produce a higher TCR than a high-return fund. But it may not have done the better job.

Let's consider two more funds: L and M, each with committed capital of \$1,000. Fund L calls all of its capital and earns 20% per year for four years (turning the \$1,000 into \$2,074). Fund M also calls all of its capital, and earns a return of 5% per year, but it goes fifteen years without selling an asset or making a distribution. In this way, Fund M turns its \$1,000 into \$2,079. According to TCR, they performed the same. But in order to turn \$1,000 into \$2,070, would you rather give up the use of your money for four years or fifteen? I'd rather be in Fund L.

How Should Performance Be Judged: IRR or TCR?

In comparing two funds, if one has a higher internal rate of return and a higher times-capital-returned, certainly it did the better job.

Year	Fund G					Fund H				
	Capital Call Jan. 1	Invested Capital Jan. 1	Annual Return (%)	Dollar Gain	12/31 Value	Capital Call Jan. 1	Invested Capital Jan. 1	Annual Return (%)	Dollar Gain	12/31 Value
1	\$300	\$ 300	10%	\$ 30	\$ 330	\$300	\$ 300	10%	\$ 30	\$ 330
2	700	1,030	20	206	1,236	700	1,030	20	206	1,236
3	0	1,236	30	371	1,607	-400	836	30	251	1,087
4	0	1,607	40	643	2,250	-400	687	40	275	962
				\$1,250					\$762	
IRR					28%					25%
TCR					2.25					1.76

Although Funds G and H had the same annual returns, Fund G's IRR is higher because it had more money invested in high-return years three and four. That gave it a higher TCR, at 2.25 (ending value of \$2,250 divided by \$1,000) as opposed to Fund H's 1.76 (ending value of \$962 plus \$800 returned, divided by \$1,000), as well as a higher IRR. With both a higher IRR and a higher TCR, it's easy to see that Fund G did better.

But it's possible for one fund to have the higher IRR and the other the higher TCR. In the following comparison, the two funds drew down their capital at the same rate and again had the same annual returns, but Fund J held on to its assets while its returns declined, whereas Fund K made significant distributions at the beginning of years three and four.

Year	Fund J					Fund K				
	Capital Call Jan. 1	Invested Capital Jan. 1	Annual Return (%)	Dollar Gain	12/31 Value	Capital Call Jan. 1	Invested Capital Jan. 1	Annual Return (%)	Dollar Gain	12/31 Value
1	\$300	\$ 300	30%	\$ 90	\$ 390	\$300	\$ 300	30%	\$ 90	\$ 390
2	700	1,090	20	218	1,308	700	1,090	20	218	1,308
3	--	1,308	10	131	1,439	-400	908	10	91	999
4	--	1,439	5	72	1,511	-400	599	5	30	629
				\$511					\$429	
IRR					13%					16%
TCR					1.51					1.43

Because Fund J didn't make any distributions, the greater amount of capital it held in low-return years three and four pulled down its IRR even as its times-capital-returned grew past that of Fund K. Fund J's ending value is \$1,511, and thus its TCR is 1.51. Fund K had ending capital of \$629 and distributed \$800, for terminal value of \$1,429 and a TCR of 1.43. But if Fund K's investors were able to earn more than \$82 in years three and four on the \$800 they got back (requiring an average annual return of 6.5%), then Fund K did a better job than Fund J. **So while we know IRR isn't perfect, TCR isn't either, as the fund with the higher TCR may not have been the better performer.** Maybe Fund K, with its lower TCR, did the better job.

How should we judge fund performance? Only thorough evaluation can lead to the right answer. Complex, multi-dimensional analysis is required. No one number can be relied on to produce a proper conclusion. Here's a list of things you have to weigh. There simply is no cookie-cutter method – no single calculation – that considers them all.

- The internal rate of return,
- The times-capital-returned,
- The percentage of the capital that was put to work,
- The speed at which that capital was put to work,
- When investments were harvested and distributions made,
- What the LPs were able to do with capital that remained uncalled and/or was returned,
- What the LPs could have done with the capital that was called and/or not returned.

Finally, it's important – as in all other areas of investing – to consider how much risk a fund took to earn its return. We've become accustomed to evaluating managers of public securities on the basis of risk-adjusted returns, but this approach hasn't equally reached the alternative markets. Part of this is because alternative assets generally haven't been marked to market, and thus there are no meaningful figures for volatility (without those simplistic measurements, risk analysis becomes a real challenge – see "Risk," January 6, 2006).

But clearly, for an oversimplified example, if buyout funds X and Y buy similar kinds of companies and end up with similar IRRs and TCRs, but Fund X uses far less leverage than Fund Y, I would tend to say that Fund X did a superior job. **Their IRRs and TCRs alone tell us nothing about their respective riskiness.**

How are we to make distinctions when the assets purchased aren't comparable or the differences in leverage and results are less than dramatic? What if one fund buys companies that are more solid than another's? How do we compare a leveraged buyout fund against an unleveraged venture capital fund (with its very low expected batting average)? Which is riskier, a highly leveraged portfolio of safe assets or an unleveraged portfolio of risky assets? It's hard to make these judgments, but that doesn't mean they're unimportant.

And while I'm on the subject of evaluating performance records, I want to raise the subject of unevenness in the quality of performance data. Some managers mark their private holdings to market and others carry them at cost. Some managers are more optimistic than others in marking to market. Some managers discount large holdings of public securities for illiquidity while others do not. And some managers highlight the results on just their realized investments, which invariably are the best. For these and other reasons, IRR or TCR figures simply can't be accepted at face value for funds that are still in operation and thus haven't turned all or almost all of their investments into cash.

Which Return Matters? – Real-Life Example #2

Another look at our real-life experience will give a clear view of the absolute conundrum posed by performance assessment. We held a first closing for Opportunities Fund IVb in May 2002, at which time we drew down \$51 million. We averaged down while Enron bonds slid and continued to draw capital and invest it as the whole distressed debt market tanked in June and July, saddling the fund with some very significant mark-to-market losses in percentage terms.

The market bottomed in August-October, by the end of which period we had gotten the fund more than 70% invested. Investor sentiment turned up dramatically in November, giving the fund a 15% gain in that month alone – now with \$1 billion invested.

Here are the results:

	<u>Time-weighted Return</u>	<u>Dollar Profit</u>
May - July	-18.6%	(\$ 33.8)
August - December	22.3	229.2
8-month totals	-0.5%	\$195.4

As you can see, the fund had a large percentage loss in the first three months and a large percentage gain in the subsequent five months. As a result, on a time-weighted basis, it showed a small overall loss for the eight months taken together.

But the fund was a lot smaller in its initial down months than it was in the later up months. Thus the LPs made a total of \$195 million . . . whereas the time-weighted return says they made no money at all.

The \$195 million dollar profit translates into a 30.7% return on the \$640 million of capital employed in the fund on average during the eight months. And that 30.7% return on average capital employed annualizes to 49.4%. Finally, the annualized IRR for the eight months – the proper measure, according to the experts – was 61.4%.

So here are the returns for the fund:

Time-weighted return	-0.5%
On average capital	30.7
On average capital (annualized)	49.4
Internal rate of return	61.4

Was the fund a marginal loser or a booming success? You pay your money and you take your pick, as my mother used to say. But clearly, there's just one conclusion to be drawn with absolute certainty: **no one figure is capable of rendering a precise picture of fund performance, particularly as relates to short periods of time.**

Short-Term Success

Because IRRs are annualized returns, the results for part-year investments can be highly misleading. I feel it is always undesirable to annualize returns on part-year investments, but doing so is an unavoidable aspect of calculating their IRRs.

For me, it was the onset of option trading that first highlighted the folly of annualizing short-term results. Back around 1973, exchange-traded options came into existence (whereas prior to that time, options were an obscure corner of the investment world, traded over the counter among “put-and-call brokers”). This made trading much easier; options attracted a lot of attention; and the “buy/write” strategy became the new “silver bullet.”

In a buy/write, you buy stock and write a call option that gives someone else the right to buy the stock from you at a fixed “strike price” for a specified period of time. Suppose you buy 100 shares of XYZ at \$40 and for \$6 sell a call option that will permit someone else to buy those shares a month later at \$35. The total proceeds to you when the option is exercised will be the \$6 option premium and the \$35 exercise price, for a total of \$41. Your investment is \$40. The gain of \$1 in one month, or 2.5%, annualizes to 30%. So people walked around saying, “I just put on the XYZ buy/write at a 30% return.” But at best they would have \$41 in their pockets for every \$40 they started with, and that doesn't sound like a 30% gain to me.

(As usual, not only were the merits of a would-be silver bullet overstated, but its dangers were often overlooked. Your dollar of profit and that beautiful 30% annualized return were entirely contingent on the stock being above \$35 on the option expiration date. If the stock fell, say, from \$40 to \$30, the option would not be exercised and you would be left with stock worth \$30 and the \$6 option premium – for a total of \$36 and a loss of \$4 from the invested cost of \$40. And that 10% loss is real, not annualized!)

It's universally agreed that IRR is the right tool with which to evaluate vehicles like private equity funds. And all approaches to calculating IRR implicitly annualize the returns on investments held for less than a year and on funds that have been in existence for less than a year. There is no alternative, despite the shortcomings of annualizing.

Of course, an investment shouldn't be judged to be successful on the basis of a high IRR alone, especially if the TCR is low. Note, for example, that a 60% IRR on a \$10 investment will produce a gain of \$16 over two years, but fifty cents if the opportunity lasts just a month. Certainly the two investments cannot be described as having been equally successful.

Now more than at any other time, I hear a lot of clients say their private equity managers are producing ultra-high IRRs over very short periods of time . . . but low times-capital-returned ratios.

Dividend Recap Magic

Whenever a company borrows money, it becomes more risky, everything else being equal. Let's say a company has \$200 of debt and \$200 of shareholders' equity supporting \$400 of assets. If the value of its assets declines 50%, its assets will just equal its debt, and its equity will be gone. Now assume it borrows \$100 with which to buy additional assets, giving it \$300 of debt and \$200 of shareholders' equity supporting \$500 of assets. It only takes a decline in asset value of 40% to wipe out its equity. This demonstrates that when a company increases its debt, the impact of subsequent developments is magnified. That's why borrowing is also called leverage . . . and why borrowing makes companies riskier.

But what if it borrows money and gives it to the shareholders? Take the same company with \$200 of debt and \$200 of equity. Assume again that it borrows \$100, but this time, rather than buy assets, it distributes the cash to its equity investors. Now it has \$300 of debt and \$100 of equity supporting the same \$400 of assets, and it takes just a 25% decline in the value of its assets to erase its equity. So whereas all borrowing makes companies riskier, borrowing for dividends greatly amplifies the effect, as the assumption of debt doesn't lead to either the acquisition of productive assets or an increase in cash reserves, but merely a decrease in shareholders' equity.

For this reason, lenders should view borrowing for dividend distributions with extreme skepticism. But it is a feature of the current capital market environment – with its excess of enthusiasm and shortage of caution – that transactions designed to replace equity with debt have become commonplace. According to CSFB, in the 36 months that began April 1, 2003, \$68 billion was borrowed through high yield bond issuance or bank loans with the stated purpose of paying dividends or repurchasing stock, whereas deals of this sort were largely unheard of prior to that date. This is a clear sign of imprudence on the part of today's capital markets.

Of course, as they say in golf, “every putt makes somebody happy.” The lender's lack of caution can work to the borrower's benefit (assuming he can avoid financial mortality). In the case of dividend recaps, the beneficiaries are buyout funds and their limited partners. Certainly

companies have appreciated in value in the last few years, but a substantial portion of the high IRRs being reported by buyout funds is due to financial engineering and the availability of equity-replacement debt. Dividend recaps are permitting equity investors to take some or all of their capital off the table, reducing their capital at risk and leveraging up their reported rates of returns. But it should be noted that whereas dividend recaps raise IRRs, they don't necessarily add to investors' dollar profits. (And if they increase the total leverage on portfolio companies, they can jeopardize the recovery of any remaining investment.)

Let's say a fund buys a company for \$200 expecting to make \$40 in a year, for a 20% IRR. Assume a wacky capital market immediately lets the company borrow and dividend out \$180 through a dividend recap. Now the fund's invested capital is down to \$20, and the \$40 expected profit represents an IRR of 200% instead of 20%. The reported return is beautiful, but the fund's expected gain is still just \$40. **Dividend recaps increase fund investors' wealth only if the amounts dividended out can be reinvested profitably. Short of that, they represent financial engineering but not value creation.**

That – among other things – is the reason why I've titled this piece “You Can't Eat IRR.” A high internal rate of return does not in and of itself put money in one's pocket. Only when it's applied to a material amount of invested capital for a significant period of time does IRR produce wealth – something which is often (but not always) signified by a high TCR. Investors evaluating fund performance should look at both IRR and TCR . . . and beyond.

So, Bottom Line: Good or Bad? – Real-Life Example #3

Just as this memo was about to go to print, a friend showed me the 2005 report of a fund of funds and asked what I thought of its performance. Here are the facts: The fund was formed in mid-2001 to buy secondary partnership interests (that is, interests in funds that limited partners want to get rid of). My friend committed \$750,000. Given the carnage earlier this decade in buyout funds and, especially, venture capital funds, he felt (and still feels) his timing was quite good.

The fund's report consists of financial statements only, without any discussion to help a reader understand the implications or limitations of the figures. As concerns performance, the fund reports a since-inception internal rate of return of 27.1% and a “multiple of cost” of 1.45. So far, pretty good.

But let's go behind the numbers.

- The first thing worth noting is that only \$600,000 of my friend's \$750,000 capital commitment has been drawn down. He doesn't understand why, given the dislocation of the early 2000s, all of his money hasn't been put to work. He suspects the General Partner may have taken too much in the way of capital commitments. (And he feels particularly badly that even before his fund has become fully invested, the GP has formed a successor fund.)

- The 27.1% IRR suggests the fund has done a good job with the capital it called down, but \$150,000 remains in my friend's money market account. Thus he suspects his effective return on the entire \$750,000 is lower because of the fund's slowness in putting his money to work.
- He also suspects that the 1.45x "multiple of cost" is misleading. That is, the \$600,000 he contributed has been turned into \$873,000, for a gain to date of \$273,000. But he set aside \$750,000 for this fund, and the \$873,000 of current value (distributions plus assets still held), when added to the \$150,000 not yet drawn (for a total of \$1,023,000), represents a multiple of only 1.36 on his capital commitment.
- As of the end of 2005, the fund was roughly 4½ years old. If it had invested his \$750,000 at 27.1% for that entire period, he would have \$2,178,000. If it had just earned a 27.1% return on the \$600,000 that was actually drawn down, he would have \$1,742,000 (plus the undrawn \$150,000, for a total of \$1,892,000). And yet, he has just \$1,023,000.
- The IRR of 27.1%, if applied to his contributed \$600,000 (forget his committed \$750,000), would have produced \$1,142,000 of gains. And yet he sat at the end of 2005 with \$273,000 of actual gains. **Simplistically to me, this suggests his contributed \$600,000 has been at work earning 27.1% for only about a quarter, on average, of the 4½ years since the fund's inception.** This illustrates the shortcoming of IRR taken alone: its failure to penalize the GP for failing to put the money to work and keep it at work.
- Finally, since the fund has already returned more than half of the \$873,000 into which the \$600,000 grew, it's extremely unlikely that even further good returns will produce ultimate dollar gains approaching the amount he thinks he should have.

The fund reports an IRR of 27.1 % and a TCR of 1.45. But clearly, my friend doesn't have anything near the profit he would have had if all of the money had been invested promptly and kept invested. And the 1.45x "multiple of cost" is irrelevant to him; he wants to know what the GP made for him on his entire commitment, not just the part it drew down. Using this fund's approach to calculating the multiple, the GP looks better if it makes a few high-return investments, whereas the investor would be better served if it invested the entire committed amount – even at a materially lower return – and kept it out there longer. My friend has \$1.36 for every dollar he committed, but a 4½-year return of even 15% on his entire commitment would have given him \$1.86.

An IRR of 27.1% sounds impressive. Does it mean the fund has done a good job? It seems to me that the GP accepted more committed capital than it could invest in a timely manner, charged fees on that higher amount, put its capital out very slowly (and not yet in full), and wasn't able to keep it out for long. I doubt the fund's LPs invested to earn 36 cents over 4½ years per dollar they committed. So no, I think, not a good job.

The real bottom line is that my friend committed \$750,000 4½ years ago and has \$1,023,000 today. That's an average annual advance of 7.3%. As Clara Peller used to say in the burger commercials, "Where's the beef?"

In this case – as in many, I suspect – both the IRR and the “multiple of cost” are next to useless. It takes thought and insight to figure out how a fund did. As in all things, looking at published figures must be just the first step.

* * *

Making a lot of money with the risks under control isn't easy. It's not even easy to identify the best performing managers. Not only is the quantification of returns themselves subject to debate, but it's often far from obvious whose risk-adjusted-returns are the best. All performance assessment demands quantitative ability tempered by judgment. But there is no alternative. Reliance on a single figure can't possibly provide the answer – not even IRR.

July 12, 2006

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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.

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.

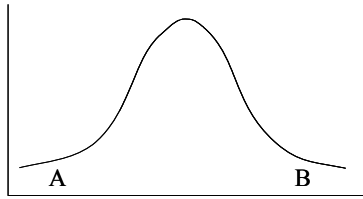
It's easy to believe that these elements are fostered in decision making groups. And certainly they are undesirable and must be guarded against. As Barton Biggs puts it,

. . . 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.

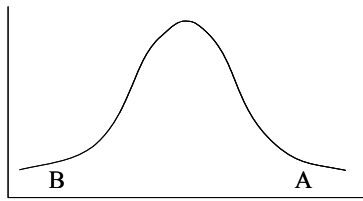
I'd rather say, "The collective intelligence of the group often is less than the intelligence of its one or two smartest members." By that I mean committees rarely aggregate the insights of their members; rather they tend to reflect the average insightfulness of their members.

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.

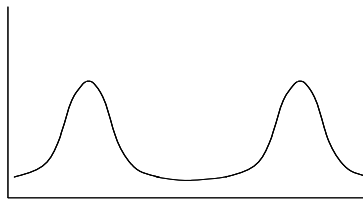
For some people, the result was a bell-shaped curve.



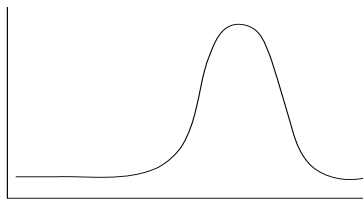
For others it was also bell-shaped, but with the placement of the industries reversed.



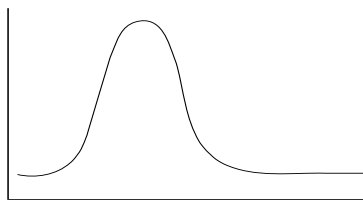
Some saw only big winners and big losers.



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

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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

- 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

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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, oversized 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

- **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

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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

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Memo to: Oaktree Clients
From: Howard Marks
Re: Everyone Knows

par·a·dox *n* **1** a seemingly absurd or self-contradictory statement that is or may be true . . . **4** an opinion that conflicts with common belief. (Collins English Dictionary)

I'm sometimes asked to speak about investing with the choice of topic wide open. I like to begin by saying the thing I find most interesting about investing is how paradoxical it is: how often the things that seem most obvious – on which everyone agrees – turn out not to be true.

I'm not saying accepted investment wisdom is sometimes valid and sometimes not. The reality is simpler and much more systematic: **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.

I've been saving up ideas for a memo about how often the investing herd is wrong and accepted wisdom should be bet against. Then along came the March 1 issue of Mark Faber's "Gloom, Boom and Doom Report" and its lead quotation from William Stanley Jevons (1835-1882). Another chance for someone else to help me say it better, this time from 100-plus years ago:

As a general rule, it is foolish to do just what other people are doing, because there are almost sure to be too many people doing the same thing.

"Common Sense" and Other Oxymorons

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.

The Anatomy of a Bargain

“Is it a good idea?” That's what everyone wants to know. And from time to time, popular opinion unites behind an investment, anointing it as a good idea – the next solution – the low-risk sure thing – the “silver bullet.” Often this crowd mentality creates a self-fulfilling prophecy . . . for a while.

I've seen it many times in my 39 years in this business: “it's a good idea to invest in the stocks of high-growth companies” (or energy stocks, small companies, disc drive companies, emerging markets, venture capital funds, technology stocks, hedge funds, real estate, China and India, or private equity). But just as often, I've stated my view: **There's no such thing as a good idea. Only a good idea at a price.** Something can be a very good idea at one price and a very bad idea at another.

Invariably when I hear the media and the herd describe something as a good buy, it's without regard for price. They never say, “Internet stocks are a good buy at p/e ratios up to 50.” Or “class-A office buildings are a good buy as long as the cap rate exceeds 7%.” Or “private equity's a good idea at purchase prices below seven times EBITDA.” Just “it's a good buy.”

My response is simple: **There is no investment idea so good that it can't be ruined by a too-high entry price. And there are few things that can't be attractive investments if bought at a low-enough price.** When investors forget these simple truths, they tend to get into trouble.

How Money Is Made

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. If someone really knew, why would he share his knowledge? And when the investing herd or some media commentator expresses an opinion, they're invariably pointing in the wrong direction.

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. As I wrote in "Dare to Be Great," non-conformists don't get to enjoy the warmth that comes with being at the center of the herd. But it should be clear that when you're one of many buying something, it's unlikely to be a special opportunity. It's only when few others will buy that you can get a bargain.

That's the thinking behind a brilliant observation that I heard in the 1970s, describing 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 believes things will get better forever.

The loners who buy from a crowd of dispirited sellers can get a good deal – and high returns – because they're few in number and early. But when every Tom, Dick and Harriet joins the herd, after the merits of the situation have become obvious to all, they can't expect a bargain; the merits must be reflected fully – or to excess – in the price. In fact, each of those latecomers bears the risk of being the last to jump on the bandwagon . . . just before it goes off the cliff.

The Best Companies in America

As readers of these memos know, I first worked in the Investment Research Department of First National City Bank (now Citibank) in 1968. Whereas common stocks traditionally were bought on the basis of their issuers' current book value and earnings, "growth investing" recently had come into fashion. Under this new approach, buyers paid higher-than-usual valuation multiples for the stocks of "growth companies" in recognition of the above-average rates at which their earnings were projected to increase in the future.

Growth investing reached its zenith in the pursuit of the "Nifty Fifty," and that's the style the bank pursued to the virtual exclusion of all others. It consisted of buying the stocks of the best, fastest-growing companies in America, companies like IBM, Xerox, Polaroid, Kodak, Hewlett Packard, Texas Instruments, Perkin Elmer, Merck, Lilly and Avon. Each one was a corporate icon, or what I call a "head nodder" – one person says "Xerox" and everyone else nods and says "great company." **Head noddors are like silver bullets: always the subject of broad, unquestioning adoration, and thus invariably overpriced.**

The trap, of course, is that when everyone agrees something's a great company, it invariably comes at a great-company price. Some will turn out to actually be great companies, but the

buyers of their stocks have already paid in full for greatness. Others will disappoint, and the stock of a disappointing company that's been bought at a great-company price can be a disaster.

By 1970, the scene had been set for just such a development by the Nifty Fifty investors' attitude toward valuation: "**These companies are so good, and growing so fast, that there's no such thing as a price that's too high.** If the price seems excessive given this year's earnings, just wait; the earnings will grow enough to justify the price." Those who participated can say they cared about price, but I never heard of anyone refusing to hold those stocks just because they were priced too high. Such discipline is rarely seen during investment manias.

The rest, as they say, is history. In the early and mid-70s, the wheels fell off. Common stock investing, which had become extremely popular, fell out of favor. Business Week ran its famous cover story, "The Death of Equities." The economy became mired in stagflation. Great companies' earnings failed to grow and sometimes contracted. Nifty Fifty stocks that had traded at p/e ratios of 80 and 90 fell to p/e ratios of 8 and 9 (really). And The Wall Street Journal eventually ran its customary listing of stocks that had lost 90% – a possible buy signal that depressed investors routinely ignore.

So we had a quick lesson in the folly of buying on supposed merit alone, without regard to price. But the lesson continued. Here in 2007, only a few of those "Best Companies in America" are still thought of as such. In fact, IBM, Xerox, Kodak and Polaroid all became distressed in the interim and required turnarounds. Warren Buffett made a related observation in this year's Berkshire Hathaway Annual Report: "Of the ten non-oil companies having the largest market capitalization in 1965 – titans such as General Motors, Sears, DuPont and Eastman Kodak – only one made the 2006 list."

The lesson is simple: beware sweeping statements, accepted wisdom and eternal verities, and look for pearls others haven't recognized.

The Worst Companies in America

I know I tend to repeat myself in these memos – my wife Nancy never fails to remind me – but I don't think I've ever told the whole story of my entry into the world of high yield bonds.

In 1978, shortly after having organized and begun to manage Citibank's convertibles securities fund, I got a call from the boss: "There's some guy named Milken or something who works for a small brokerage firm in California. He deals in 'high yield bonds,' and a client wants us to manage a portfolio for them; can you find out what they are?" Obviously, that brief conversation changed my life.

Everyone associates Michael Milken with high yield bonds (no one says "junk" anymore), but few people know exactly why or how. Mike was neither the inventor (first to create) nor the discoverer (first to find) of bonds rated below investment grade. He's just the person who did the most with them. Here are the facts:

- For as long as bonds have been rated, there've been low-rated bonds. But prior to the late 1970s, non-investment grade bonds couldn't be issued as such. Rather, they were "fallen angels": bonds issued with investment-grade ratings that were subsequently downgraded due to deterioration on the part of their issuers.
- At Wharton, Mike read a 1958 study by W. Braddock Hickman which showed that over the period 1900 to 1949, lower-rated bonds had produced higher realized returns on average than higher-rated bonds. Sure some low-rated bonds defaulted, but higher yields and lower purchase prices on the many that didn't default more than made up for the ones that did.
- Mike concluded that low-rated bonds were an overlooked asset class; even for a weak credit, there had to be some yield that would compensate for the credit risk; thus it should be possible to issue bonds with speculative ratings; and he could make it happen.
- Thus Mike's contribution consisted of raising the profile of the asset class and proselytizing for it, making a market in high yield bonds and underwriting new issues. He wasn't the only one, just the most prominent figure by far. And the expansion of the universe of new issue high yield bonds from \$2 billion to \$200 billion that Mike presided over between 1978 and 1990 provided early impetus for the growth of buyout investing into the major activity it is today.

By the time I got the call described above, Mike had joined Drexel Burnham Lambert, started the high yield bond department, moved it to California and begun to underwrite new issue high yield bonds for corporate borrowers. He visited me at the bank in the fall of 1978, and it was even more of a learning experience than the one I got from the Nifty Fifty. Mike's logic was the direct opposite, and to me much more appealing. Here's what he told me:

- If you buy triple-A or double-A bonds, there's only one way for them to go: down. The surprises are invariably negative, and the record shows that few top-rated bonds remain so for very long.
- On the other hand, if you buy B-rated bonds and they survive, all the surprises will be on the upside.
- Because the investment process is prejudiced against high yield bonds, they offer yields that more than compensate for the risk.
- Thus you'll earn a superior yield for having accepted the incremental credit risk, and favorable developments can lead to capital gains as well.
- Your main goal should be to weed out bonds that may default.
- But diversification is essential, too, because some of the bonds you hold will default anyway, and your positions in them mustn't be large enough to jeopardize the overall return.

What an object lesson! What an epiphany! Buy the stocks of the best companies in America at prices that assume nothing can go wrong? Or buy the bonds of unloved companies at prices that overstate the risk of default, and from which the surprises are likely to be on the upside? Having seen fortunes lost investing in the best, it seemed much smarter to buy the worst at too-low prices.

“If we avoid the losers, the winners will take care of themselves.” Sound familiar? The motto we chose for Oaktree was inspired by a lot of people and events, but the morning I spent with Mike Milken in 1978 was the biggest single source of inspiration.

The Perversity of Risk

“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.

The foregoing must be what Lord Keynes had in mind when he coined one of my favorite phrases: “. . . 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.” In 1978, triple-A bonds were considered respectable investments, while buying B-rated bonds was viewed as irresponsible speculation. Yet the latter have vastly outperformed the former, few of which remain triple-A today.

Elevated popular opinion, then, isn’t just the source of low return potential, but also of high risk. Broad distrust, disregard and dismissal, on the other hand, can set the stage for high returns earned with low risk. This observation captures the essence of contrarianism.

The Unhelpful Consensus

The bottom line is that what “everyone knows” isn’t at all helpful in investing. What everyone knows is bound to already be reflected in the price, meaning a buyer is paying for whatever it is that everyone thinks they know. Thus, if the consensus view is right, it’s likely to produce an average return. And if the consensus turns out to be too rosy, everyone’s likely to suffer together. That’s why I remind people that merely being right doesn’t lead to superior investment results. If you’re right and the consensus is right, your return won’t be anything to write home about. **To be superior, you have to be more right than the average investor.**

Let me give you an outstanding example of a dangerous consensus. Historic data, buttressed by two decades of good returns, produced near unanimity in the late 1990s regarding future equity returns. Ask 100 institutional investors and consultants in 1999, and virtually 100 would say “about 11%.” There was little serious dissent. As a result, equity allocations were ratcheted up. Those who’d fallen behind because they were underweighted in equities earlier in the decade capitulated and bought more.

Where did the support for that 11% number come from? It’s simple: recent results. Earlier work at the University of Chicago had put the average annual return on stocks closer to 9% into the 1960s, but a couple of decades of much higher returns pushed the cumulative experience – and thus the expectation – toward 11%. Shouldn’t there have been support apart from experience? Was there an underlying economic process that would make stocks worth 11% more each year? Couldn’t the last fifteen years, averaging well above 11%, have borrowed from the future by pushing up p/e ratios? Few people inquired. “You can’t fight the tape,” they said in essence. Who was willing to take the risk associated with a below-average weighting?

Well, the elevated prices produced by that unanimously positive expectation, a reversal of the optimism it embodied, and the fact that those above-trend results had in fact borrowed heavily from the future all led eventually to the first three-year decline in equities since 1930. And, not surprisingly, to a new consensus. Now everyone says “about 7%.” But is today’s consensus any more likely to be right? Or does it just reflect more of that oxymoronic quality, common sense?

Asset Class Returns

Further on the topic of consensus expectations, let me visit the question of whether asset classes even “have” expected returns. I learned from managing fixed income portfolios that bonds come closest to having a dependable return. Over its life, a bond that’s bought at a 10% yield to maturity and doesn’t default will return 10%, won’t it? An obvious truth? No, actually something of a misstatement.

The majority of the lifetime return on a long-term bond comes not from the promised interest payments and redemption at maturity, but from the interest earned on interest payments after they’re received. The yield to maturity at which a bond is bought expresses the overall return that will be earned if interest rates don’t change – that is, if interest payments are reinvested at the rates prevailing at the time of purchase. But because interest rates are highly variable, so is the “interest on interest” component. Few non-bond people realize how un-fixed even fixed

income investing is, and how substantial is the “reinvestment risk.” And beyond bonds, it’s even more up for grabs.

What rate of return is implicit in equity investing? Certainly we should look to more than just returns over the last ten or twenty years for the answer. The rate of growth in corporate profits provides a clue, but in the short run, changes in p/e ratios tend to swamp changes in profits.

In 1999, investors asked, “What’s been the return on common stocks?” and were seduced by the 11% answer propounded by authorities like Prof. Jeremy Siegel in his book, “Stocks for the Long Run.” What they should have asked, however, is, “**What’s been the return on common stocks bought when the Standard & Poor’s 500 was priced at 29 times earnings?**” (which it was at the time). In other words, people made the mistake of believing that common stocks have a single rate of return you can depend on, regardless of entry point. **They forgot the great extent to which the return on an asset is dependent on the price you pay for it.**

In the March/April 1997 issue of the Financial Analysts Journal, Peter Bernstein set forth a helpful way to consider returns from equities – one I’d thought about but had never seen in use. He calculated returns on the S&P 500 for periods spanning widely separated dates between which the p/e ratio didn’t change. He called the result “valuation-adjusted long-run equity returns.” In December 2006, he published some interesting results. With the S&P 500 trading at 17.2 times earnings, he looked at four periods which had begun with the p/e at the same 17.2 and found that the returns over those periods had ranged from 10.4% to 11.1%.

In other words, over periods when multiples were unchanged, the S&P 500 did deliver roughly 11%. And in the very long run, over the course of which the impact of p/e fluctuations is watered down, stocks also have returned 11%. Thus it seemed reasonable for buyers of stocks in 1999 to expect returns of 11% per year. But they failed to think about what might happen if p/e ratios fell in the short run.

It shouldn’t take a Ph.D. (or even an MBA) to know that if you buy the S&P in 1999 at a p/e ratio of 29, one of the highest multiples ever seen, the p/e ratio could decline and the resulting return could be below 11% – well below 11% if it happened quickly. In 1999, investors derived excessive comfort from an optimistic consensus that was based on long-run data. But in 2002, they were licking wounds inflicted in the short run. It’s worth noting that for the seven years that ended March 31, 2007, the annualized return on the S&P 500 was 0.9%. **So much for the crowd’s certainty regarding 11%.**

And what about the return on private equity? Before saying what it’ll be, investors should think about where returns come from. Some markets derive their returns from an underlying process. As far as I’m concerned, owning interests in money-making companies and income-producing real estate has such an underlying basis for returns, whereas owning gold and art does not.

Companies produce profits, and thus buying interests in them represents buying into a stream of returns. When a private equity fund buys a company today at nine times EBITDA (which, let’s say, equates to eleven times cash flow after capital expenditure needs), that implies a 9% free-cash-flow return on invested capital – and maybe 5% after fees and expenses. The rest of the return that’s hoped for must come from doing other things: leveraging up the equity at a cost

below 9%, making the company more productive, or selling it at an increased valuation. But the ability to do these things is either highly dependent on market conditions (leveraging cheap or selling dear) or skill-based. The wide disparity among private equity results for any given period of time shows how much they are a function of the skill of the general partners, and thus that most of the return on private equity is far from intrinsic to the asset class.

Everyone Knows

Two years ago, the herd knew residential real estate was a can't-miss way to build wealth. "You can live in it," "it's a hedge against inflation," and "they're not making any more land" were oft-recited mantras . . . just as they had been in the mid-1980s (See "There They Go Again," April 2005). After ten years of rapid appreciation, owners of condos felt they had it made, and non-owners felt they were on the outside looking in. People lined up to put down deposits on condos that hadn't been built yet, and many assembled portfolios that way.

No one talks that way anymore. The air came out of the condo balloon fast once prices stopped going up, putting the virtuous circle into a stall. The cheap financing that appeared to provide a ticket to financial security is now seen to have lured many buyers into water over their heads. **"It can only go up" and "if it stops working, I'll get out" – two phrases that are heard in the course of virtually every financial mania – proved once again to be highly flawed.**

To avoid the trap in residential real estate, one needed a memory of events that occurred more than ten years earlier, the ability to understand their implications, and the discipline to resist joining the herd. Many failed the test and succumbed to yet another investment craze.

Just think about the many things everyone agreed on in the last decade, and how overdone these fads turned out to be – or may turn out to be in the future.

- "Everyone" loved emerging markets in the mid-90s, with their concept of per capita consumption catch-up . . . until the Russian debt debacle and the collapse of Long-Term Capital Management busted that bubble for a while.
- A fellow member of a non-profit investment committee insisted in 1999 that we had to invest the endowment in a hi-tech fund . . . just before its portfolio lost more than 90%.
- Hedge funds were widely touted as the surefire solution to the weakness that stocks demonstrated in 2000-02, in time to see the average return recede to unexciting single digits.

Great recent performance and a failure to detect risky patterns have cost investors money on several recent occasions . . . and always will. Now silver bullets ranging from private equity to art are being touted as ways to make big money without risk . . . ignoring the unlikely nature of that proposition, as usual. There's plenty of evidence of the popularity of these ideas. Maybe they'll work forever. Maybe these trees will grow to the sky. But if they do, they'll be the first.

* * *

Finally, it's important to remember that investment trends regularly go to great extremes, meaning "overpriced" and "overdone" are far from synonymous with "going down tomorrow." As Lord Keynes said, "The market can remain irrational longer than you can remain solvent." Thus, whatever it is the herd is favoring, a manager might either (a) hold a little to ensure that it doesn't continue doing well without him on board, making constituents question his judgment, or (b) avoid holding any, but he should be prepared to look wrong for a while. Anyone who's tempted to blow the whistle on a market trend just because it has gone too far or is priced too high must bear in mind one of the greatest adages of all: **"Being too far ahead of your time is indistinguishable from being wrong."**

There's always a period – sometimes a long one – when those who follow the crowd look smart and the abstainers look dumb. But the roles are inevitably reversed in the long run. **Insisting on buying value and controlling risk can seem awfully dowdy at times, but for us, there is no other way.**

April 26, 2007

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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

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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

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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

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

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Memo to: Oaktree Clients
From: Howard Marks
Re: No Different This Time – The Lessons of ‘07

On July 16, I published a memo called “It’s All Good.” I wrote it while on vacation in late June and early July, and then it took a week after my return to get it out. It reviewed the excesses that had occurred in the preceding few years and the extent to which people were overlooking them, thinking instead that everything was ideal and would stay that way. It discussed the recurring tendency of investors in bullish times to feel that “it’s different this time” – that the process which caused past cyclical highs to correct wouldn’t apply in the current instance.

The bullish balloon remained unpunctured as of July 16, and some may have thought my memo unduly pessimistic. It’s a good thing it didn’t take another week or two to put it out, however, because by July 30, things had started to go bad, set off by defaults among subprime mortgages and downgrades of securities based on them.

“An isolated development,” the bulls replied, as is usual when the first crack in the dam appears. It’s hard to believe that less than five months later, the effects are widespread, significant losses have been registered, and negativism has taken over from euphoria. No one doubts that we’re in the throes of a full-fledged credit crunch. But in that way, **it truly is no different this time.**

Investor Behavior in a Low-Return Market

Each player must accept the cards life deals him or her. But once they are in hand, he or she alone must decide how to play the cards in order to win the game.

I found that quote on the wall of a Melbourne, Australia coffee shop last month, with an attribution to Voltaire. I was struck immediately by its applicability to the financial markets. As I’ve pointed out in the past, we must never overlook the need to deal with the investment environment **as it is**. The environment is the product of natural phenomena as well as the decisions made by millions of “economic units” such as consumers, investors, companies and nations. We are presented with it, and no one of us can alter it. What matters is what we do with it.

To succeed as investors, we must recognize the environment for what it is and act accordingly. In any given environment, some actions will lead to success and others to failure. Which is which varies greatly over time. Our first task as investors is to assess the environment and map a course which is appropriate for it.

As I noted a few years ago, (see “Risk and Return Today,” October 2004) we were living in a low-return world. The prospective returns offered on traditionally safe investments were low in the absolute. Moving out on the risk curve added little to expected returns; i.e., risk premiums were in many cases at record lows. Overall, then, the Capital Market Line – the risk/return curve – was “low and flat.” In all, the rewards offered for risk bearing were paltry.

So what was an investor to do in that low-return world? You could make your usual investments and accept returns below those you’re used to, perhaps deciding to allocate your capital for the long term and ignore the short term. Or you could decline to invest and hold cash instead, despite the fact that the expected return for doing so is invariably the lowest. Or – as I think most people did – you could reject the low returns available on your usual investments and go for more. **That is, you could insist on achieving high returns in a low-return world.** But insisting on them is one thing, and positioning your portfolio to get them is another. How might the latter be accomplished?

The answer is simple: many reached for return. Primarily that meant making riskier investments or using leverage to increase the capital at risk (or both). That’s the main story of the last few years, and the reason behind the jam the markets are in today.

So What Happened?

As I wrote in “Risk and Return Today,” in recent years investors did things they’d never done before – or hadn’t done as much of – because they wanted more than the 4-5% they could get in high grade bonds and the 6-7% they felt they could expect from U.S. equities. They put more into hedge funds, for example, and their commitments expanded the largest buyout funds from \$3-5 billion to \$20 billion-plus in just a year or two.

Investors succumbed to the siren song of leverage. They borrowed cheap short-term funds – the shorter the cheaper (you can get money cheap if you’re willing to pledge assets and promise repayment monthly). And they used that money to buy assets that offered higher returns because they entailed illiquidity and/or fundamental risk. And institutional investors all over the world took Wall Street up on the newest promises of two “silver bullets” that would provide high returns with low risk: securitization and structure.

On the surface, these investments made sense. They promised satisfactory absolute returns, as the returns on the leveraged purchases would more than pay the cost of capital. The results would be great . . . as long as nothing untoward happened.

But, as usual, the pursuit of profit led to mistakes. The expected returns looked good, but the range of possible outcomes included some very nasty ones. The success of many

techniques and structures depended on the future looking like the past. And many of the “modern miracles” that were relied on were untested.

A Dearth of Skepticism

Unlike market bottoms, where investors are too skeptical, during upswings most people believe too much, worry too little and fail to apply enough skepticism. Since all investors want a good deal – and see the people around them making money so easily – they tend to jump aboard. They want to see the good times roll on, not to pour cold water on the party by questioning what’s going on.

Everyone dreams of easy riches – of high returns earned without risk. Wall Street comes up with surefire solutions to which the hopeful flock, such as portfolio insurance in the 1980s and dot-com IPOs in the 1990s. In the current decade, investors became convinced that securitized mortgages and highly leveraged entities offered the magic solution. People who long ago stopped believing in Santa Claus jumped aboard, and now they’re disappointed. But past results never deter new generations of dreamers from chasing the next silver bullet.

In the last few years, people accepted myths that now have been exposed. Let’s review a few:

- In 2006-07, we heard a lot of talk to the effect that **disintermediation had reduced risk**. Because lending banks were moving loans off their books through syndication to other banks and non-bank lenders alike, the risk residing at any one bank – and thus in the financial system as a whole – had been reduced. Of course, the feeling that the world had become a safer place led many participants to take on more risk than they otherwise would. **And where are we seeing the biggest losses reported? At those supposedly safer banks.**
- A lot of people have lost money as a result of **excessive reliance on credit ratings**. How is it, for example, that investors are showing up with such large losses on mortgage-related CDO debt? Well, rather than accept the low yields on AA-rated corporate bonds, they went for the AA-rated tranches from CDOs . . . because they offered higher yields. **But wait a minute! More yield for the same quality? A free lunch? Not likely.** Maybe the buyers relied too much on ratings in lieu of their own due diligence. Maybe the credit rating agencies didn’t fully understand the debt under review, or had biases which led to too-high ratings. Maybe they didn’t intend the AA rating on CDO debt to mean the same thing as an AA rating on corporate debt. And maybe the rating-agency analysts lacked the above-average skills that are needed to add value in the investment world; if they possessed them, wouldn’t they be spending their time more lucratively as investors?
- Perhaps most telling, it seems people were willing to drink up without asking, **“Who’s paying the tab?”** Take the CDO creation process: Acting on behalf of a

Widespread failings of skepticism are significant in two ways. Individually, each one represents a way to lose money through an ill-considered investment. And collectively, they're indicative of the market climate. In times of excess on the upside, fairy tales gain currency and encourage risk taking. And then they are debunked, as is happening today. **Or as Warren Buffett puts it, “when the tide goes out, we find out who’s been swimming without a bathing suit.” This time around, the answer is “lots of people.”**

The Magic of Leverage

It’s obvious that the key element in many of the errors that tripped up investors this time around was cheap and easy credit, utilized without much awareness of risk. An oversupply of capital looking for a home in non-traditional investments caused vast sums to be pushed into mortgage loans at low-cost teaser rates to un-creditworthy homebuyers who often weren’t required to document their incomes. It let hedge funds bulk up on the carry trade and buyout funds bid enough to acquire world-class companies, taking on enough leverage to target high expected returns. And it was the building block supporting CLOs, CDOs, CDO²s, conduits, SIVs and other highly leveraged entities.

The Fed delivered cheap credit for the best of reasons: to counter the depressing effects of the emerging market crisis, 9/11, the tech bubble bust, the first three-year stock market decline since the Depression, Y2K, the telecom meltdown, concern about deflation, and whatever else was on its mind. Interest rates were the lowest most of us had ever seen, anchored by 1% on cash. The low rates both (a) drove down returns on investments at the safe end of the risk curve and (b) provided the fuel for elevated risk taking.

One must never forget that leverage doesn’t make investments better; it just magnifies the gains and losses. Since most investments have a positive expected value, meaning that gains are expected on average, leverage has the effect of appearing to enhance the expected return. And most of the time, that works just fine.

But once in a while, something goes awry. Maybe asset prices go so high they become unreportable. Maybe the analysis behind an investment proves to have been faulty.

Maybe an exogenous event negatively influences asset prices or funding availability or both. And maybe they all happen at once. When the unlikely occurs – when asset prices decline unexpectedly – the impact as magnified by leverage can be unbearable, setting off a negative chain reaction.

Falling asset prices cause lenders to shy away from providing credit, and eventually to demand repayment. With credit less available, repayment might have to come from asset sales, putting additional downward pressure on prices in an already unaccommodating market. Prices go down further; confidence worsens; lenders grow more cautious; and credit becomes even less available. **What used to be a virtuous circle becomes a vicious circle. This is how credit crunches occur.**

There is a recurring element in most investor meltdowns. Lured by attractive promised returns or spurred on by the perceived inadequacy of unleveraged returns, **investors borrow short-term capital with which to buy long-term assets.** And then eventually there comes a bad day, on which the short-term capital flows out (in response to demands for repayment, the maturing of borrowings, or investor withdrawals). And on that particular day, perhaps (a) the outgoing capital can't be replaced and (b) portfolio assets can't be sold at fair prices. Sales, if feasible, may have to be made at prices so low that, if all the assets were marked there, the entity's net worth would be negative. That's it: meltdown. That's what happened this summer to Bear Stearns's High-Grade Structured Credit Strategies Enhanced Leveraged Fund. It happened to Long-Term Capital Management in 1998 and to the Granite Fund in 1994. And it'll happen again – because financial memory is short and the attraction of leverage can be irresistible.

Investors must remember that it's not enough that an investment has a good expected return, or that the negative outcomes are unlikely. One of the overlooked effects of leverage is that it “fattens the tails” – increases the likelihood of extreme outcomes in both directions – and worsens the consequences of negative events. **Every portfolio or investing entity must be examined to make sure it will be able to survive that bad day – that it has been set up so the interaction of its terms, its borrowings and the riskiness of its assets won't cause it to implode.** Of course, this leads to the question of how negative a set of circumstances we should allow for. Each investor's degree of risk averseness will determine what level of negative developments a portfolio should be built to withstand. But certainly these are topics that must be considered.

When I think about investors using leverage to try to wring acceptable results from low-return investments, it seems like folly. Let's see: You have \$100 to invest, and you come across a fundamentally sound investment that yields 6%. But you consider the 6% return too low. So rather than buy \$100 worth, you borrow another \$400 at 5% interest and buy \$500 worth. If you can borrow at 5% and invest at 6%, each “turn” of leverage adds 1% to your expected return. Thus, in addition to the \$6 earned on your own \$100 of capital, you'll earn an additional \$1 per \$100 of borrowed capital, or \$4 on \$400. Thus the total return on your \$100 of capital, leveraged four times, is \$10. Voila! That inadequate 6% return has been turned into a handsome 10%.

But wait a minute. Remember, you originally thought the 6% return on the investment was too low. What happens when everyone comes to agree that it should be higher? Well, the normal way for an investment's prospective return to go up is for its price to fall. **So now, with help from leverage, you've bought five times as much of an asset that's under-returning and due for a price decline. It all reminds me of my friend Sandy, whose favorite restaurant review is "the food's terrible, but the portions are huge." In this case, it's "the return's inadequate, but thanks to leverage you can buy a lot."** Is that a good thing?

Garbage In, Garbage Out

This expression was in broad circulation 10-20 years ago, but I haven't heard it much lately. It's meaning is simple: models and decision-making processes can't produce good decisions if they don't begin from valid inputs. Roughly stated, I think all computers can do is maintain and search data bases, compare one thing against another, and perform calculations. They cannot think (yet).

I think the importance of this for financial decision makers is that while computers can find, verify and extrapolate relationships that have held in the past, they can't tell when those relationships will cease to work and what new relationships will take their place.

Put another way, computers know a lot about the past but much less about the future. In order for computers – or people lacking foresight, for that matter – to know what will happen in the future, they need reliable data regarding the past and an ability to expect that the future will be like the past. People were let down in both regards in 2007.

Most people have heard of "value at risk," or VAR, a worst-case estimate of a portfolio's one-day loss potential. *The Economist* reported on November 1 that on no fewer than 16 trading days in the third quarter (a quarter of all the days), UBS's trading losses exceeded the VAR calculated the preceding day. In all the preceding years since UBS began to use VAR in 1998, there hadn't been one such day. What went wrong? Maybe VAR isn't a good measure. Maybe the data UBS used was erroneous. Maybe the model was based on a period that was atypical or too short to be statistically significant. Or maybe the world changed, invalidating the model.

In the last few years, financial alchemy led to the creation of large numbers of high-rated securities out of pools of low-grade mortgages. Investors relied on the ratings, and I suppose the rating agencies relied on default rate assumptions that looked reasonable in the light of experience. But they didn't allow for changed circumstances (e.g., for the fact that since mortgage initiators no longer risked their own money for long, they had stopped making lending decisions the way they used to). It's for reasons like this that assumptions can turn out to be inappropriate.

I'm not saying you can't invest profitably when the inputs are garbage. But only after critically assessing the reliability of assumptions can sufficient allowance for risk be built in via demands for an appropriate risk premium. In the last few years, people bought "safe" securities where they really had little understanding of their workings or foundations. The results are now clear.

I'm Shocked . . . Shocked

Given that market upswings are often accompanied by insufficient skepticism, it's not unusual for lofty expectations to be disappointed. A story on Citibank's results in the Wall Street Journal of November 2 contained words such as "unnerved" and "unsettled." Few things have a more corrosive effect on investor psychology than disillusionment like we're seeing today.

I remember getting a kick out of an article that ran in the Wall Street Journal around 1991. After taking big losses in high yield bonds, a mutual fund investor was quoted as saying, "I thought I was investing in a high yield bond fund. If I'd known it was a junk bond fund, I never would've bought it." It's common for investors to act without adequate understanding, and for them to feel betrayed when their hopes are unfulfilled. This time they're saying, "It was rated triple-A, and now no one can tell me what it's worth."

The disillusionment has been swift and dramatic (not to mention terrifying). Most CDO investors must now realize they had no idea how the mechanisms would work or how much risk they were taking. Holders have seen investment grade debt downgraded to single-C in a single rating action. Investors in Bear Stearns's High-Grade Structured Credit Strategies Enhanced Leveraged Fund lost all their money, finding no protection in all those great adjectives. Some assets became unsalable at any reasonable price. A lot of asset-backed commercial paper became unrenovable. And \$5 billion anticipated writedowns turned into \$8 billion actual writedowns in just a few weeks.

In a statement that seems representative of this period, Marcel Rohner, the Chief Executive of UBS, said last week the "ultimate value of our subprime holdings . . . remains unknowable." I don't doubt that it is, and for that reason his statement calls to mind a 2005 memo titled "Hindsight First, Please (or, What Were They Thinking?)." Why couldn't investors figure out in advance that the result of these investments were unpredictable? What caused them to make investments that now are described that way? It truly makes me wonder what they were thinking.

The Challenge of Managing Risk

One of the reasons investor confidence has been hit so hard 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.

1. **Risk exists only in the future, and it's impossible to know for sure what the future holds. Or as Peter Bernstein puts it, "Risk means more things can happen than will happen . . ."** 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 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 may appear to be the case.
2. **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 this past 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.
3. 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.
4. **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

5. **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 67 years ago: “. . .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.
6. **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.
7. **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’s going on now.**

Recapping the Lessons – Nothing New

The markets are a classroom where lessons are taught every day. The keys to investment success lie in observing and learning, which is what I’ve tried to do in the 40 years since I got my first job at Citibank.

I think the credit cycle that began around 2002 will go down as one of the most extreme on record and be the subject of discussion for years to come. It is one of the most important, potentially most serious financial episodes I've witnessed, and it presents a great learning experience. (Of course, it's said that "experience is what you got when you didn't get what you wanted.")

People were blindsided this summer when the financial markets went wobbly in just a few weeks on the basis of unhappiness in a remote corner of the mortgage market. But nothing that happened should have come as a surprise. While the details of each financial crisis may seem new and different, the major themes behind them are usually the same, and several were repeated in the current cycle. Not one of the following twelve lessons is specific to 2007 or to subprime mortgages or CDOs. And each one is something I've seen at work before.

1. **Too much capital availability makes money flow to the wrong places.** When capital is scarce and in demand, investors are faced with allocation choices regarding the best use for their capital, and they get to make their decisions with patience and discipline. But when there's too much capital chasing too few ideas, investments will be made that do not deserve to be made.
2. **When capital goes where it shouldn't, bad things happen.** In times of capital market stringency, deserving borrowers are turned away. But when money's everywhere, unqualified borrowers are offered money on a silver platter. The inevitable results include delinquencies, bankruptcies and losses.
3. **When capital is in oversupply, investors compete for deals by accepting low returns and a slender margin for error.** When people want to buy something, their competition takes the form of an auction in which they bid higher and higher. When you think about it, bidding more for something is the same as saying you'll take less for your money. Thus the bids for investments can be viewed as a statement of how little return investors demand and how much risk they're willing to accept.
4. **Widespread disregard for risk creates great risk.** "Nothing can go wrong." "No price is too high." "Someone will always pay me more for it." "If I don't move quickly, someone else will buy it." Statements like these indicate that risk is being given short shrift. This cycle's version saw people think that because they were buying better companies or financing with more borrower-friendly debt, buyout transactions could support larger and larger amounts of leverage. This caused them to ignore the risk of untoward developments and the danger inherent in highly leveraged capital structures.
5. **Inadequate due diligence leads to investment losses.** The best defense against loss is thorough, insightful analysis and insistence on what Warren Buffett calls "margin for error." But in hot markets, people worry about missing out, not about losing money, and time-consuming, skeptical analysis becomes the province of old fogeys.

6. **In heady times, capital is devoted to innovative investments, many of which fail the test of time.** Bullish investors focus on what might work, not what might go wrong. Eagerness takes over from prudence, causing people to accept new investment products they don't understand. Later, they wonder what they could have been thinking.
7. **Hidden fault lines running through portfolios can make the prices of seemingly unrelated assets move in tandem.** It's easier to assess the return and risk of an investment than to understand how it will move relative to others. Correlation is often underestimated, especially because of the degree to which it increases in crisis. **A portfolio may appear to be diversified as to asset class, industry and geography, but in tough times, non-fundamental factors such as margin calls, frozen markets and a general rise in risk aversion can become dominant, affecting everything similarly.**
8. **Psychological and technical factors can swamp fundamentals.** In the long run, value creation and destruction are driven by fundamentals such as economic trends, companies' earnings, demand for products and the skillfulness of managements. But in the short run, markets are highly responsive to investor psychology and the technical factors that influence the supply and demand for assets. In fact, I think confidence matters more than anything else in the short run. Anything can happen in this regard, with results that are both unpredictable and irrational.
9. **Markets change, invalidating models.** Accounts of the difficulties of "quant" funds center on the failure of computer models and their underlying assumptions. The computers that run portfolios primarily attempt to profit from patterns that held true in past markets. They can't predict changes in those patterns; they can't anticipate aberrant periods; and thus they generally overestimate the reliability of past norms.
10. **Leverage magnifies outcomes but doesn't add value.** It can make great sense to use leverage to increase your investment in assets at bargain prices offering high promised returns or generous risk premiums. But it can be dangerous to use leverage to buy more of assets that offer low returns or narrow risk spreads – in other words, assets that are fully priced or overpriced. **It makes little sense to use leverage to try to turn inadequate returns into adequate returns.**
11. **Excesses correct.** When investor psychology is extremely rosy and markets are "priced for perfection" – based on an assumption that things will always be good – the scene is set for capital destruction. It may happen because investors' assumptions turn out to be too optimistic, because negative events occur, or simply because too-high prices collapse of their own weight.
12. **Investment survival has to be achieved in the short run, not on average over the long run.** That's why we must never forget the six-foot-tall man who drowned crossing the stream that was five feet deep on average. **Investors have to make it through the low points. Because ensuring the ability to do so under adverse**

Most of these twelve lessons can be reduced to just one: be alert to what's going on around you with regard to the supply/demand balance for investable funds and the eagerness to spend them. We know what it feels like when there's too little capital around and great hesitance to part with it (like now). Worthwhile investments can go begging, and business can slow throughout the economy. It's called a credit crunch. But the opposite deserves to receive no less attention. There's no official term for it, so "too much money chasing too few ideas" may have to do. **Regardless of what it's called, an oversupply of capital and the accompanying dearth of prudence such as we saw in the last few years – with their pernicious effects – can be dangerous for your investing health and must be recognized and dealt with.**

All of the rules enumerated above can be depended on to take effect . . . eventually. But rarely do they operate on schedule. That's why, as markets go further to excess, more and more people join in bullish behavior at worse and worse moments. Remember, though, as Larry Summers put it, "in economics things happen slower than you expected they would, but when they finally do, they happen faster than you imagined they could."

These are the themes behind the current crisis. Master them and you'll have a better chance of side-stepping the next one.

December 17, 2007

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Memo to: Oaktree Clients

From: Howard Marks

Re: Now What?

My memos mostly try to explain what's been going on in the financial arena and how things got that way. With three published this past summer plus December's review of the lessons of 2007, I've done a lot of that. Hopefully they were helpful. Given what I consider to be the importance of the current situation, I have decided to venture beyond the familiar ground and into an area where I'm on shakier footing: the future. Before doing so, however, I can't resist the temptation to recap how we got here.

Boom

There's a process through which bullish excesses set the stage for bearish corrections. It's known as "boom/bust," a label that succinctly describes the last few years and, I think, the next few.

- In 2001-02, heavy borrowing to overbuild optical fiber capacity led the telecommunications industry to the brink of financial collapse. This came to a head around the time that scandals were unearthed at Enron, WorldCom, Adelphia, Tyco and Global Crossing. This combination of events – set against the backdrop of a sluggish economy and some very negative geo-political events – led to a **widespread crisis of confidence regarding corporate financial statements, corporate managements and corporate debt**. The environment was quite bleak.
- The Fed took interest rates as low as 1% to offset the negative effects of these events and others. Because of this – and with U.S. equities having fallen for three consecutive years for the first time since the Great Depression – many investors concluded that their **return aspirations couldn't be met in traditional investments**. Pressure for higher returns had the effect of increasing the acceptance of alternative investments, hedge funds, emerging market securities, leverage and financial innovation . . . in the process, suppressing customary risk aversion.
- **Leverage and risk taking became the dominant features of the financial landscape**, facilitated by a "global wall of liquidity." The low promised return on most investments, the pressure for more and the availability of low-cost capital all combined to make leveraged structures the flavor of the day.
- Importantly, much of the growth in leverage took place free of regulatory oversight. In the past, the creation of debt was limited by margin requirements, Fed regulations, bank capital requirements and bankers' prudence. But under the new order, **an**

explosion of non-bank lending rendered the traditional restraints impotent, with unregulated hedge funds and derivative traders doing what financial institutions wouldn't or couldn't. And when traditional providers of capital did participate, competition to lend caused them to join in the trend to "covenant-lite," "PIK/toggle" and other loosey-goosey structures.

- Financial innovation enjoyed enormous popularity. **The application of leverage, securitization and tranching permitted debt backed by assets such as mortgages to be created and sold around the world.** This process, it was said, enabled just the right level of risk and return to be delivered to each investor.
- Financial sector participants and observers concluded that the world had been made a less risky place by disintermediation (in which banks sold off loans rather than hold them), adroit central bank management and developments that made debt more borrower-friendly. In many cases, this **sense of reduced risk** encouraged individuals to assume correspondingly more risk.
- Because the structured products were so new, sophisticated and opaque, **high ratings would be needed** if they were to gain acceptance. Wall Street's persuasiveness, combined with the rating agencies' susceptibility, caused the needed ratings to be assigned. Thus the final element was in place for the financial innovations to gain widespread popularity.
- Among the innovations, **collateralized debt obligations**, or CDOs, deserve particular mention. CDO originators would issue tranches of debt with varying levels of priority regarding the cash flows from debt portfolios assembled with the proceeds. In many cases, the portfolios consisted heavily of residential mortgage-backed securities, each comprised of large numbers of mortgages, often subprime. I find it inconceivable that buyers of CDO debt really understood the riskiness of the tranching of leveraged pools of tranching mortgage securities underlaid by thousands of anonymous loans. But solid ratings made the debt highly salable.
- With vast sums available for high-fee investment products, **managers' incentives favored the rapid amassing and deploying of large pools of capital.** The usual effect of such a process is to drive up asset prices, drive down prospective returns and narrow investors' margin of safety. It was no different this time.
- Due to widespread prosperity, large amounts of capital flowing into the mortgage market, and the flowering of the American dream of home ownership (and of wealth therefrom), **rapid home price appreciation became a prominent feature of this period.** Price gains further inflamed the people's hopes, and behavior regarding residential real estate grew increasingly speculative.
- Thanks to the combination of the wealth effect from home appreciation, the ability to borrow liberally against increased home equity, and strong competition among financial institutions to provide credit, **consumer spending grew faster than**

As this process moved onward, it depended on a continued supply of the underlying ingredients: confidence, liquidity, leverage, risk tolerance and acceptance of untested structures. The resulting “virtuous circle” was described in glowing terms just as its perpetuation was growing increasingly unlikely.

Bust

It took five years or so for the bullish background described above to be established in full. As usual, far less time was required for the excesses to be exposed and the process of their unwinding to begin. The air always goes out of the balloon a lot faster than it went in.

Regular readers know that if there’s one thing I believe in, perhaps more strongly than anything else, it’s the fact that cycles will prevail and excesses will correct. For the bullish phase described above to hold sway, the environment had to be characterized by greed, optimism, exuberance, confidence, credulity, daring, risk tolerance and aggressiveness. But these traits will not govern a market forever. Eventually they will give way to fear, pessimism, prudence, uncertainty, skepticism, caution, risk aversion and reticence. A lot of this has happened.

Busts are the product of booms, and I’m convinced it’s usually more correct to attribute a bust to the excesses of the preceding boom than to the specific event that sets off the correction. But most of the time there is a spark that starts the swing from bullish to bearish. This time it came in the world of subprime mortgages.

Subprime mortgages (as if there’s a person alive who doesn’t know) are loans made to people whose credit scores fall below the “prime” standards that government-sponsored agencies Fannie Mae and Freddie Mac require of the loans they buy. In the last few years, as part of the rosy process described above, subprime mortgages were issued in rapidly increasing numbers. They were often placed by independent mortgage originators paid for volume rather than credit quality; through salesmanship that caused excessive amounts to be borrowed; for the purchase of highly appreciated homes; with temporarily low “teaser” interest rates; in structures that reduced or delayed principal repayment; and without requiring borrowers to document the incomes they claimed. **Of course, with the clarity that comes with hindsight, everyone now sees that these elements constituted breeding grounds for trouble.**

Anyway, here’s how things went:

- In late 2006 and early 2007, **defaults among subprime mortgages began to rise.** But as is usually the case with the first crack in the financial dam, this attracted little attention and was generally described as an “isolated development.”

- By July 2007, however, the defaults became serious and could no longer be ignored. This precipitated **wholesale downgradings of CDO debt securities**.
- The **defaults and downgrades led to price declines**. This caused leveraged investment entities that held CDO debt to receive margin calls and capital withdrawals. When they went to the market to sell the debt to raise cash, they found either that it couldn't be sold or that the bids were way below fair value. When some investors announced significant losses, the mark-to-model approach often used for pricing was questioned and then rejected in favor of market prices.
- In times of crisis, you sell what you can sell, not what you want to sell. Many of the entities that held CDO debt also held leveraged loans (the new term for bank loans, since most banks no longer hold on to loans for long). Thus, **when they couldn't get fair prices for CDO debt, they sold leveraged loans**, putting their prices under pressure as well. And when the creation of new Collateralized Loan Obligations slowed to a trickle, the decline in demand from CLOs removed an important prop from loan prices.
- Some leveraged entities that couldn't sell enough CDO debt (or other holdings) at fair prices suspended withdrawals. In extreme cases, they melted down and investors lost everything. In sum, **entities that had borrowed short to invest in longer-term, potentially illiquid assets fell victim to their funding mismatch**. The precariousness of this position is easy to overlook when all is going well, asset prices are firm and capital is freely available. But it regularly leads to ruin when financial crises take hold.
- With these developments, **psychology turned from positive to negative overnight**. Lenders became more nervous, requiring repayments, raising lending standards and refusing to roll over maturing loans. In particular, there was a dramatic contraction in the market for commercial paper backed by assets (rather than by promises from creditworthy firms).
- Among other things, **the investment banks found their balance sheets clogged with debt for buyouts** that they had promised to place ("bridge loans") before the music stopped, and the debt became unsalable on the agreed terms. This cut into their ability to make new loans. Discount sales were talked of, and funds were formed to buy up the loans.
- **Central banks stepped in to calm the waters**. The European bank injected significant capital. The Fed cut short-term rates. The Bank of England guaranteed deposits at Northern Rock, a building society (S&L), and extended emergency loans. And so the panic eased. The reaction seemed to be "boy, I'm glad that's over." But the calm lasted only from early September to mid-October.

- CDO downgrades continued, price declines deepened, and **financial institutions began to report third-quarter losses on mortgage-related holdings**. These occurred around the world, but they were concentrated in U.S. commercial and investment banks. There was some surprise when it turned out that, despite disintermediation, banks still had ended up holding the bag. Also surprising was the fact that new and unheard-of types of (usually bank-controlled) off-balance-sheet entities – structured investment vehicles (“SIVs”) and conduits – were among the big losers. Because some couldn’t renew their asset-backed financing, their debts had to be taken onto the banks’ balance sheets (to avoid holding fire sales in order to repay lenders), bringing the supposedly alchemical process of disintermediation full circle.
- **Banks warned of fourth-quarter losses**, people wondered whether the warnings were sufficient, executives lost jobs, and suppliers of credit became even more restrictive. Due to the combined effect of losing equity to writedowns and having to take SIV debt onto balance sheets, there was **talk of bank equity capital becoming inadequate**. Citigroup found it appropriate to sell convertible equity to Abu Dhabi with an 11% starting dividend, and others like UBS and Merrill Lynch followed suit.
- Mortgage lending ground to a near halt, even for “prime” borrowers. Homebuilders and housing-related retailers issued profit warnings. Inventories of unsold homes swelled. A few money market funds threatened to “break the buck” and had to be rescued. Towns in Norway that had bought CDO debt neared insolvency. Florida’s pooled fund for localities had to suspend withdrawals. Mono-line insurers that had guaranteed mortgage-related securities came under pressure, casting doubt on the safety of municipal bonds they had insured. **The “isolated development” had sprouted surprising and widespread repercussions.**

In just four months – from mid-July to mid-November – we saw the development of a full-fledged credit crunch, with that term regularly appearing in the headlines. Whereas anyone could get money for any purpose a year earlier, now deserving borrowers had a tough time securing funds.

And there you have it: five pages devoted to the past in a memo about the future.

Clouds on the Horizon

The Fed and other central banks have taken strong action to lower the cost of credit and inject reserves into the system. And in the last month or so, things went quiet. But with everyone back from the holidays, events are likely to heat up again.

Clearly things have just begun to be sorted out in the financial sector. Year-end pricing of mortgage-related securities may bring further writedowns. Auditors may view low prices as more defensible than high ones, and avoiding legal risk can influence their decisions. Conservative auditors will do battle with bank managements desirous of maintaining equity reserves and financial flexibility. On the other hand, there may be a

wish on the part of managements – especially new ones – to clear the decks by marking down or selling off problem assets. All of this may result in bigger losses in the short run.

There's still some mystery about whether mortgage losses will pop up in new places. For example, relatively little has been reported by insurance companies and pension funds. We also thought Asian institutions were big buyers of CDO paper over the past year or two, yet nothing's been heard from them to date.

Fundamentals are really bad in the housing sector: Record home price declines. High levels of foreclosure, and neighborhoods where for-sale signs are everywhere. Swollen inventories of unsold homes. Mortgage interest rate resets that are likely to add further to the above. Very low sale volumes (meaning sellers haven't adjusted to reality in terms of the prices it'll take to tempt buyers). Financing and refinancing difficult to obtain. People unable to buy homes because they can't sell the ones they own.

What will happen to mortgage defaults? It's hard to say how bad it'll get. Anyone who bought a home in 2005-07 and borrowed a high percentage of the cost is likely to be "upside-down" – that is, to owe more on the mortgage than the house is worth. Will these people keep on making mortgage payments? And what will happen as interest rates reset from teaser to market? Will borrowers be able to afford the increased payments? Will they stop paying on car loans and credit cards to make the mortgage payment? Or are the former more essential for survival in the short run?

Implications for the Broader Economy

Everyone wants to know whether there's a recession ahead. They're even asking me . . . someone who certainly doesn't know.

I don't think about it much. First of all, thinking isn't going to produce a useful answer. People have opinions, and while they may be considered opinions, I wouldn't bet on whether they'll be right. Most people say the probability is about 40-50%, which I think is their way of saying they don't know but they feel it's not unlikely.

A recession is a technical matter: two consecutive quarters of negative real growth. Sure, recessions are bad, but if there isn't a recession, that doesn't mean everything's okay. **What matters to us is whether the economy will or won't be sluggish. It is generally believed that highly leveraged companies run into trouble and defaults rise significantly when economic growth falls below 2% per annum.**

Several things suggest that in the months and perhaps a year or two ahead, economic growth will be less than vibrant. Many are related to the consumer. The housing situation described above particularly bodes ill.

- Rising mortgage payments are likely to hinder consumer spending.
- It's hard to believe consumer psychology will be positive. With home prices well below the levels of a year or two ago, the "wealth effect" will be negative. Feeling poorer is likely to discourage consumer spending. So is negative news about the economy, and the receipt of much larger bills for gasoline and heating.
- The combination of rising home prices and generous capital markets in the past permitted home equity to be withdrawn and spent. Neither of those is likely to be a positive in the near future.

Consumer spending is the engine of the U.S. economy's growth. I just don't see it staying strong. I heard the other day that we should applaud consumers' "resilience": their willingness to spend even when incomes and news are negative. Personally, I find it frightening. Eventually there'll be a day of reckoning for spending growth which isn't supported by income growth – that is, for dissaving.

The second element with a negative prognosis is capital availability. Banks' losses on mortgage-related securities have eaten into both (a) the capital they need to support their lending and (b) their appetite for risk. Less credit is available to hedge funds and private equity funds. Fewer CDOs and CLOs will be formed in the near future, so they won't be able to provide debt capital as aggressively as they did in the past. **Just as leverage and willingness to bear risk were the twin engines of the recent boom, so their reduction is likely to cause things to slow.**

Third, business expansion is unlikely to contribute to growth. Already-slow holiday spending, employment growth and orders for durables are unlikely to encourage businesses to expand production, build inventories or create jobs. The announcement of corporations' fourth quarter results in a month or so will give us a hint regarding direction.

The main offset to concern about a slowdown comes from overseas. In the past, a recession in the U.S. was sure to have effects worldwide. Now, it seems possible that developing economies such as those of China and India will see enough demand from elsewhere – including domestic demand – to avoid importing our slowdown. The most optimistic case holds that foreign demand might avert a recession in the U.S. Such demand could be buttressed by the softness of the dollar, which makes our goods very attractive to buyers spending foreign currencies. We'll see.

As usual, there are optimists and pessimists. The optimists see enough strength to offset the effect of the mortgage losses. The pessimists think a massive contraction in the prices of assets – mostly homes – implies a calamitous contraction that can only be averted through massive government action (if at all). We won't bet on which is right, but we believe the economy – and thus business – will be less vibrant in the period ahead than it has been.

The Fed's Dilemma

Investors are hoping the Fed will ride to the rescue with rate cuts and capital injections that bolster the economy. It did so in September, allowing sentiment to improve and debt prices to recover for a while, and again in December.

The markets rejoice when the Fed cuts rates (all but the bond market, which worries that rekindled inflation will push up interest rates, which will push down bond prices). Personally, I think a rate cut sends a mixed message. It implies help is on the way, but it makes me wonder about the peril that made the Fed take the step. It's like the guy who goes to the doctor and sees him pull out a gigantic hypodermic. Nice to know he's getting treatment, but isn't the condition worrisome? Along those lines, the Fed's 50 basis point cut on September 14, which exceeded most expectations, caused *breakingviews.com* to run the headline "Does Ben [Bernanke] know something we don't?"

Around November 27, investors concluded they could count on a significant rate cut, causing the Dow to move up 546 points in just the next two days. Surely they think lower rates will stimulate the economy and help offset the credit crunch. But here are the counters:

- **Will making money cheaper cause financial institutions to borrow and lend, or people to borrow and spend?** Can a rate cut offset the frightening aspects of declining creditworthiness? Low interest costs provide scant compensation when loans go unpaid. Thus the Fed can offer cheap money, but it can't make people borrow it, spend it or risk it. The phrase for that problem is "pushing on a string." It's a big part of the reason why Japanese economic growth has never been successfully restarted. For this reason, some observers are suggesting that Washington add fiscal stimulus (tax cuts and spending increases) to the Fed's monetary policy. In this way, consumers' reticence can be offset by direct government spending.
- **Will fear of rising inflation deter the Fed from stimulative action?** In general, central bankers view their primary job as keeping inflation from accelerating as the economy grows. Avoiding slowdowns is usually secondary. Prices are moving up sharply in food and fuel, and the overall rate of inflation has broken out from the low levels of the past decade. This may limit the Fed's freedom to stimulate the economy and risk a reheating. And I hear some worry about a return to the "stagflation" of the 1970s, in which inflation roared ahead but economic growth couldn't gain traction.
- **What will lower rates do to the willingness of foreigners to hold dollar reserves?** We need foreigners to hold dollar-denominated securities. They're the swing buyers of billions of dollars of Treasury securities each year. If they won't do so, who'll finance our fiscal and trade deficits? If investing at U.S. interest rates is seen as implying too great an opportunity cost, a spreading conclusion that dollar holdings are unattractive will put us in quite a financing pickle. Of course, this worry will be

- **Finally, the Fed has to think about moral hazard.** Yes, the Fed wants to prevent financial catastrophes and widespread resulting pain. But at the same time, it doesn't want to give risk takers the impression that they can count on the central bank to make them whole, and thus encourage greater adventurousness in the future. The Fed will have to balance its reluctance to rescue sophisticated speculators against its desire to protect "innocent bystanders."

I'm sure the Fed will take strong steps to keep the credit crunch from becoming as bad as it otherwise might. But there are limits on its freedom to take action and its ability to save the day.

Averting Fire Sales

Many of the full-blown crises I've seen have been caused (or exacerbated) by the following process, which eventually ends in something commonly called a fire sale:

- take on short-term capital,
- invest it in longer-term or illiquid assets,
- experience price declines and writedowns that eliminate your resolve to hold, unsettle your suppliers of capital and/or jeopardize your capital adequacy,
- receive a margin call or capital withdrawal notice,
- need to raise cash on a day of market chaos, and
- be forced to sell into an inhospitable market regardless of price.

In the distressed debt funds that we organized in 1990 and 2002, both times of chaos in financial markets, we earned net IRRs in the 30s and 40s. If you think about it, those IRRs have to be described as aberrant. No one should be able to earn returns like those without significant leverage. And yet we did. Like all active investors, we try to buy things for less than they're worth. **The above results suggest we were aided in those funds by people who were willing to sell things far below their worth.** Why would they do so? Often because of the fire sale process described above.

Not surprisingly, our financial leaders are attempting to short-circuit this process. Mortgage defaults are real and widespread and will produce losses for holders of related securities. Eventually those losses will have to be recognized and dealt with. But I think several of the actions we're seeing are aimed at avoiding exaggerated, panicked fire sales:

- injections of liquidity,
- mortgage reset holiday,
- taking SIVs (and their debt) onto balance sheets, and
- proposing a Super-SIV (which now seems to be history).

But we need to recognize that in addition to potentially enriching buyers of distressed assets, fire sales clear problems from balance sheets and speed solutions. They bring pain and chaos, but they also move things ahead. One of the reasons for Japan's lingering malaise may be that it denied its bad-debt problems for too long, allowing sluggishness to dominate the economy. The questions in the U.S. and Europe will be what's being done and whether it will work.

I looked at the Super-SIV particularly quizzically. Its avowed purpose was to prevent fire sales on the part of SIVs that had financed debt purchases with asset-backed commercial paper that couldn't be rolled over. So financial institutions would fund an entity that would buy assets rather than require their sale in the open market, where they would bring lower prices. But that's perverting economics! Let's see: "We'll buy something for 90 rather than see it come to a frozen market where it might bring 70. Yes, we'll buy it now even though we might have gotten a chance later to buy it for less." That just shouldn't happen, and now it appears it won't, as the Super-SIV mission has been scrubbed.

A Word on the Monoline Insurers

I usually emphasize discussion of macro developments, but at this time there's a micro story that very much deserves telling. Over the last two decades, a few companies developed the business of insuring municipal bonds. Since this was their only business, they're called monoline insurers. Because of the extremely low historic frequency of defaults on munis, a relatively small amount of capital was enough to allow MBIA, Ambac and a handful of smaller companies to guarantee the payments on \$2 trillion of municipal bonds.

In the last few years, rather than be left behind as old fogeys, these companies "got modern" like almost everyone else: in addition to munis, they began to insure leveraged entities such as CDOs. And like everyone else, the actuarial calculations they used to determine how much debt they could afford to insure and the premiums they should charge were based on default experience from a brief period that shouldn't have been extrapolated. Thus, like so many others, they took on propositions that have trashed their balance sheets, with grave implications for their basic business.

Here's where it gets interesting. Many muni buyers either want or are required to hold only AAA-rated bonds. And many munis gained their AAA ratings not because the issuers were eminently creditworthy, but because they were insured by companies with AAA ratings. But several of the insurers have landed on the credit rating agencies' watchlists for downgrades, given the possibly unknowable risks they assumed. **If they lose their AAA ratings – and thus the bonds they insured do so as well – will there be a rush of muni holders to the exit? A fire sale at which buyers are scarce?**

One or more of the insurers may need injections of equity capital to bolster their reserves. But what price will investors pay for their stock? (Warburg Pincus committed to invest

in MBIA about a month ago, when the stock was at \$31, and today it's less than half that). And if the potential CDO losses are so great that a monoline insurer's net worth may be negative on an expected value basis, would anyone put in equity capital when the first of it basically will go to cover creditors? Certainly the monolines' future has been complicated by Warren Buffett's decision to compete by forming a new company that's not burdened by a CDO legacy.

A relatively minor sideshow, but one very much worth watching. And one which illustrates the potential of "isolated developments" to have surprisingly widespread ramifications.

The Shoe That Hasn't Dropped

Amid all the chaos, one area has been unaffected thus far: corporate credit-worthiness. Defaults on high yield bonds and non-investment-grade loans are usually the site of most of the pain in this area, and to date there have been almost none.

Defaults among high yield bonds have averaged 4.2% over the last 20+ years and reached double digits in 1990-91 and 2001-02, giving us huge opportunities to buy depressed assets. In contrast, over the last year or two defaults have been near 25-year lows . . . and practically zero. Oaktree's high yield bond portfolios are in their 47th month without a default. Will default rates on high yield bonds reach or exceed the historic average? And how will the new asset class of leveraged loans weather its first test?

First, with a **slower economy**, there's every reason to believe creditworthiness will decline and defaults will rise. It's just hard to believe that the incidence of default will be unaffected if the economic environment turns less salutary.

Second, over the last few years we've seen a **highly elevated level of buyout activity**, with deals priced at increasing multiples of cash flow and financed with rising proportions of debt. Better companies can support higher debt levels, and some of the buyouts have been of top companies. But we feel that prices and leverage ratios have been high in the absolute, and that competition to buy companies in a heated environment made buyout funds stretch on purchase price. **Some of the assumptions underlying these deals undoubtedly will prove to have been overly optimistic**, and eventually we'll have the opportunity to buy debt in those deals at discounts.

Non-performing debt related to leveraged buyouts gave us great buying opportunities when the LBOs of the 1980s cratered in 1990. Chastened providers of capital cut back their lending in the 1990s, and thus buyouts didn't contribute to the 2002 debt crisis. But we expect unsuccessful buyouts to be a primary source of distressed opportunities in the next go-round. Given the high volume of non-investment-grade debt issuance recently, even a moderate rate of default implies a heavy supply of distressed debt, contributing to the perception of a credit meltdown.

Third, lots of potential defaults will be delayed or prevented because recent issuance has emphasized **issuer-friendly debt**. Default occurs when an interest payment isn't made or a debt covenant (non-cash financial requirement) is breached. But in some recent issues, the borrowers obtained the right to pay interest for a while in the form of additional debt ("toggle" bonds, because the borrower can throw the switch), and in some there were few if any maintenance covenants ("covenant-lite" debt). Some borrowers also arranged for standby credit facilities, giving them further financial flexibility in tough times. Fewer tripwires – fewer defaults. These features will delay defaults but won't necessarily preclude them. It all depends on what happens in the period between the day the default otherwise would have occurred and the day the music has to be faced. Maybe there'll be fewer defaults. Maybe bigger ones. And anyway, there's lots of "normal" (non-issuer-friendly) debt outstanding, especially in connection with small- and mid-size buyouts.

In addition, it's not as if debt became more borrower-friendly without there being a response. **Financial engineers, who decide what risks can be taken on the basis of what's likely, don't see risk decline and leave it at that. They tend to build back the risk so as to fully utilize their "risk budget."** So I imagine people said, "Debt has become easier to bear; let's take on more of it." Which is safer: a company with a moderate amount of demanding debt, or one which has been highly levered with debt that's less burdensome? The answer is that you can't tell without knowing how things will unfold. You certainly can't say the latter company is less risky than the former.

Buyouts in **Europe** have been at least as aggressive as in the U.S. and on average have been associated with less solid companies. In addition, Europe has never seen a full-fledged debt crisis, and the first one could be traumatic. Thus we expect numerous defaults and lots of discounted debt there. On the other hand, **Asia** hasn't yet been the site of many highly leveraged buyouts, so high levels of defaults and distress don't figure into our expectations for Asia. Maybe next cycle, after some aggressive buyouts have taken place there.

Looking ahead, private equity will be subject to crosscurrents. The less accommodating capital markets will have a number of effects:

- Buyout funds will find it harder to finance acquisitions, especially large ones.
- Similarly, a lot of existing buyout debt won't be refinanceable on the same terms in the new environment.
- The speed and ease of recaps will be reduced, rendering quick withdrawals of equity capital at ultra-high IRRs much less likely.
- It will be harder for funds to achieve profitable exits, as would-be buyers from private equity funds won't find it as easy to finance purchases or pay high prices, and IPOs will be an uncertain route to realizations.
- But these same factors will also affect the competition to invest, meaning private equity funds' purchase prices in the future will likely be lower than they otherwise would have been.

Finally, underperforming companies will crop up in private equity portfolios, and the need for turnarounds and restructurings will take up time and pull down returns.

In many ways, the private equity industry may have to operate as it did in an earlier era, when funds were smaller, the volume of transactions was more moderate, both purchase and sale prices were lower, holding periods were longer, and IRRs were lower (but perhaps more meaningful in terms of times-capital-returned). Funds will have to make money the way they used to, with more emphasis on buying cheap and adding value and less on financial engineering and quick flips. Large funds formed within the last 12-18 months may find themselves uninvested for a while, and thus in high-fee limbo.

* * *

It's worth remembering that the boom of the last few years arose in the financial sector, not the "real world." Economies grew around the world – as did corporate profits – but there was no economic boom other than in developing nations. **It was optimism, risk tolerance, innovation, liquidity, leverage, credulity and the race to compete that reached multi-generational highs. Thus the ramifications will be (actually, have been) felt first and most strongly in the financial sector. The question is how far they'll spread from there.**

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. That can be enough to make highly leveraged transactions falter.

I've said many times that for each period there's a mistake waiting to be made. Sometimes it's buying too much, and sometimes it's buying too little. Sometimes it's being too aggressive, and sometimes it's not being aggressive enough. Which it is depends on the combination of the going-in opportunities and the environment that unfolds.

What mistake is on offer today? How aggressive should one be? **Although the extent of the coming softness has yet to be fully defined, I feel we're in the second or third inning.** (For readers who aren't followers of baseball, that means the standard nine-inning game has barely begun.) I recently read a piece asserting that we're still singing the national anthem before the start of a game destined to go beyond nine innings, but I find it hard to engage in such extreme thinking. The damage has begun to be felt and the correction has begun to take place.

Nevertheless, I do think we're in the early going: the pain of price declines hasn't been felt in full (other than perhaps in the mortgage sector), and it's too soon to be aggressive. Things are somewhat cheaper (e.g., yield spreads on high yield bonds went from all-time lows in June to "normal" in November) but not yet on the bargain counter. **Thus, I'd recommend that clients begin to explore possible areas for investment, identify competent managers and take modest action. But still cautiously, and committing a fraction of their reserves.**

"Don't try to catch a falling knife." That bit of purported wisdom is being heard a lot nowadays. Like other adages, it can be entirely appropriate in some instances, while in others it's nothing but an excuse for failing to think independently. Yes, it can be dangerous to jump in after the first price decline. But it's unprofessional to hang back and refuse to buy when asset prices have fallen greatly, just because it's less scary to "wait for the dust to settle." It's not easy to tell the difference, but that's our job. We've made a lot of money catching falling knives in the last two decades. **Certainly we'll never let that old saw deter us from taking action when our analysis tells us there are bargains to be had.**

In the period leading up to the current crisis, investors acted like they were loaded down with too much cash and desperate to put it to work. To do so, they ventured into uncharted waters and unknowingly accepted high risks in investments providing less-than-commensurate compensation. **With too much money chasing too few deals, the bargaining power was in the hands of the takers of capital.** They used it to their advantage, making deals that were good for them but bad for the suppliers of capital. **In the period ahead, cash will be king,** and those able and willing to provide it will be holding the cards. This is yet another of the standard cyclical reversals, and it will afford bargain hunters a much better time than they had in 2003-07.

Some of those who came to the rescue of troubled financial firms in 2007 may have jumped in too soon. There's a fair chance they didn't allow maximum pain to be felt before acting, (although the prices they paid eventually may turn out to have been attractive). **I'd mostly let things drop in the period just ahead. My view of cycles tells me the correction of past excesses will give us great opportunities to invest over the next year or two.**

January 10, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: Whodunit

who·dun·it – (hōō dun' it) *n.* a narrative dealing with a murder or a series of murders and the detection of the criminal (The Random House Dictionary of the English Language)

The subprime crisis, credit crunch and possible recession are subjects of daily conversation. In addition to wanting to talk about how things got this way and what's going to happen in the future, a lot of people are eager to discuss who's to blame. It's the purpose of this memo to say where I think responsibility lies.

The Subprime Factory

I've heard it said about laws that, "like sausages, you don't want to see how they're made." I'd like to suggest something else where the manufacturing process was particularly distasteful: subprime mortgages.

This decade's vast expansion of the subprime factory originated in the ability of **Wall Street** to sell a lot of mortgage-related Collateralized Debt Obligations, or CDOs. The high interest rates on subprime mortgages enabled the Street to promise a lot of return on the lower CDO tranches and a lot of safety on the upper ones. With high-enough ratings, the debt looked very attractive to potential buyers. Thus, there was a use for large amounts of the underlying raw material: subprime mortgages. It happened, however, that Wall Street could sell more bologna sandwiches than there was bologna. That is, there was more appetite for securities built from high yielding mortgages than there were qualified borrowers. No problem: just provide incentives to increase production and turn a blind eye to creditworthiness.

Mortgage brokers played an essential and often ugly part in this process. They were tasked with creating mortgages in quantity, and that's where their incentives lay. **Since neither they nor the Wall Street firms would hold the mortgages for long, the emphasis was on volume rather than creditworthiness.** Making loans was good; rejections were bad. The website of broker Kevin Schmidt's firm in Louisiana said it best, "We don't get paid unless we say YES." (*The Wall Street Journal*, January 17) The *Journal* went on to point out that, "Key players often get a cut from what a transaction is supposed to be worth when first structured, not what it actually delivers in the long term."

Thus I believe mortgage brokers committed many sins. They offered more debt than many subprime borrowers could carry. They assured borrowers that they'd always be able to refinance into new loans at teaser rates, so they needn't worry about a reset to market rates. They probably weren't clear on all the terms and practiced the old bait-and-switch. They hid from first-mortgage lenders the fact that borrowers were borrowing their equity too. And I'm sure some encouraged borrowers to lie about their incomes, invoking "Everyone does it," "Why should Joe and Sue have a nicer house than you?" and "Nobody gets hurt."

Appraisers made a similarly negative contribution to the process. In the days when home prices were stable, appraisals were based on established parameters like price per square foot. But with prices rising rapidly, they could only reference "comps" to other highly appreciated homes. **Like the credit rating agencies, appraisers lent a veneer of respectability to a faulty process.** And like rating agencies, the job probably went to the appraiser willing to assign the highest value. I've read about appraisers being black-listed because they were too conservative, restraining loan volume. According to the *L.A. Times* of January 27, a Wharton professor, Susan Wachter, has estimated that "appraisers helped inflate mortgage values by \$135 billion during 2006 alone." Borrowers, home sellers, mortgage brokers and Wall Street all had a vested interest in seeing high values assigned. **There's something fundamentally wrong when there's no party to a transaction who wants the appraisal to be conservative.** But that became the case when far-away, ratings-assured buyers of sliced-and-diced mortgage securities took the place of lenders risking their own money and expecting to hold to maturity.

Mortgage insurers played a similar role by lending their imprimatur and thus implying instruments were safe. Everyone thinks of taking out insurance as a cautious thing to do. When risks are insured, the people exposed to them believe they're safe to behave differently than they otherwise would. But what happens when the insurers miscalculate the risks involved, and thus issue more coverage than their capital can support in tough times? In the extreme, losses can go unreimbursed, meaning the insureds don't really have the protection they think they have and their situation is riskier than they intended. **Certainly in this cycle, insufficiently cautious insurers abetted the bearing of risks that have exceeded expectations.**

Let's remember that the **mortgage borrowers** don't deserve a free pass. It was stupidity or cupidity, naïveté or moral turpitude. At best they took on massive financial responsibilities they didn't understand, and at worst they were fraudsters. Many took out "no-doc loans" at interest rates above those charged on loans requiring documentation of income. Why? I assume they wanted to be free to lie. And many agreed to terms they couldn't decipher. But why worry, if the result is a great house at a low initial monthly payment (and maybe cash taken out in the process)? I hate to see the borrowers' suffering, but each one willingly participated in a deal that was too good to be true.

Turning Mortgage Loans into CDOs

CDO investors are in the headlines for having lost \$100 billion-plus (thus far) on subprime-related obligations. Someone sold them something that turned out to have been massively overpriced. Thus I have to start with the **investment bankers**. Again, was it naïveté or avarice?

When Oaktree considers a new product, we ask a number of questions: First, will it work for our clients; what's the return potential; and are the risks controllable? And second, can we sell it; and will it be profitable for us? Which of these did Wall Street ask regarding subprime CDOs? The second group of questions undoubtedly, but the results provide no assurance regarding the first. They sold something that failed massively, and they've gotten off somewhat easy in terms of society's judgment. Fittingly, investment banks like Merrill Lynch, Citigroup and UBS ate a lot of their own cooking (and a good part of the losses). But that does not absolve them of responsibility, for others were hurt as well.

I believe firmly in *caveat emptor*, but that doesn't mean there's no such thing as misconduct on the part of sellers. Did they perform thoughtful and balanced due diligence? Did they give enough thought to the buyers' downside risk? Did they suspect that the good deal might be illusory? Did they see the flaws in the mortgage origination process? When they marshaled data with which to prove to customers and rating agencies that CDOs were secure, did they consider the data's sparseness or limited relevance? Did they fail to disclose information regarding the "exceptions" in CDO portfolios – mortgages that didn't meet minimum lending standards – as the New York Attorney General is investigating (*WSJ*, January 31)?

Some of the same questions can be asked about the role of **CDO managers**. I haven't been close to the process – Oaktree didn't have any involvement – but I believe managers met with investment bankers who offered a near-turnkey proposal: "Here's how it works. The documents are ready to go. We have the assets in inventory. The debt is teed up for issuance. Your fees will be x million per billion." Did the managers vet the process? Did they undertake an independent effort to gauge the risks? Or did they just sign on to the magical fee machine?

Next up, in my opinion, are the **credit rating agencies**. In summary, everything was wrong with the process through which CDO debt was rated, a process fed by the agencies' hunger for profit. The agencies worked with CDO sponsors to design the products, so how could they then be objective in evaluating them? They accepted payment from the companies whose offerings they were rating; they all did, but that doesn't mean the arrangement left them objective. They competed for the business, with the fees going to the agency that would assign the highest rating.

But in the end, the rating agencies' greatest failing lay in giving their blessing to securities whose risk they couldn't accurately assess. The eventual default rate was crucial and unknowable. The historic data on subprime defaults related to mortgages that

were issued through a far different process and incentive system. But I can't imagine any agency saying, "The risks are unknowable; we just can't assign a rating."

How do we know the agencies bobbled the ball? The **twelve-digit losses** to date give a pretty good indication. An article in *The Wall Street Journal* of January 31 gives another:

Standard & Poor's downgraded or threatened to downgrade more than 8,000 mortgage investments and projected a widening array of financial institutions would ultimately face mortgage securities losses totaling more than \$265 billion. . .

S&P's rating actions touched on \$534 billion in mortgage-related investments, including 47% of the U.S. subprime mortgage bonds rated in 2006 and the first half of 2007. . .

S&P . . . has now placed 69% of the triple-A rated subprime bonds from 2006 on negative watch. (emphasis added).

I'd call that a thorough indictment. It indicates a flawed process, not occasional error.

The situation is remarkably similar for the **monoline insurers** . . . but with an added wrinkle. These firms carved out a good but dull and slow-growing business in insuring municipal bonds. Since munis default so infrequently, they needed little in the way of capital to cover potential losses, and they probably started to feel they were pretty good at gauging losses. In the 1990s, they concluded that mortgage-backed securities were no more risky than munis. (Not so, it turns out: MBIA recorded mortgage-related losses of \$714 million in the fourth quarter, versus losses of \$920 million on munis over its 36-year history, for an average of \$26 million a year.) Thus the insurers applied their capital and acumen to insuring \$125 billion of CDO debt. They acted out of the same ignorance as the rating agencies, **but they promised to make good on any losses.**

The results are potentially disastrous. Their capital is clearly insufficient to cover their responsibilities. ACA Financial Guaranty Corp., for example, wrote \$69 billion of credit protection on the basis of its \$425 million of capital. And if CDO losses eat into the monoline insurers' capital and/or cause them to lose their triple-A ratings, it will diminish the reliability of their assurance with regard to \$1 trillion-plus of munis they backed. Loss of the triple-A rating would hurt the outstanding insured munis, wreak havoc in the muni market generally, and make it harder for new bonds to be issued, at just the time that cities and states need money to cover economy- and subprime-related revenue declines. Also of critical importance, it will require holders of insured CDO paper to take additional writedowns. The monoline situation has begun to contribute to the credit crisis, and people are scurrying to find a solution (thus far without success).

All the participants in the CDO creation process took part in an activity we can call "ratings arbitrage." If you can take a bunch of assets with low ratings and – without adding to the intrinsic value of the collateral in any way – turn them into securities with

much higher average ratings, you can make a lot of money. But the ability to do so means there's something wrong. (In other words, if it's possible to start with 100 pounds of hamburger and end up selling ten pounds of dog food, 40 pounds of sirloin and 50 pounds of filet mignon, the truth-in-labeling rules can't be working.) **In the case of CDOs, ratings and insurance were supplied by parties who underestimated the risk, and the end product was sold – and bought – by people who were willing to participate in this purported miracle without asking the hard questions.**

The Failure of Risk Management

I've long been critical of risk management as a distinct investment discipline. Now, a convincing case for my view can be made on the basis of *prima facie* evidence: The fact that most financial institutions appointed **risk managers** after the collapse of Long-Term Capital Management in 1998 doesn't seem to have helped them avoid the subprime mess.

If you trust someone to be expert enough to make an investment, then that's the person who can best assess its risk. If you trust someone to assemble portfolios, it's they who can best judge how things will behave in combination. In the isolated risk management function, I feel people who know less about the underlying investments second guess the people who know more.

There's an ongoing dilemma, as expressed in a joke I posted on my bulletin board in 1970, about the fact that analysts know a great deal about a few things, while portfolio managers know a little bit about a lot of things. In my view, however, risk managers know the littlest bit about the most things, so they're least suited to evaluate portfolio risk.

In December's "No Different this Time," I included a discussion of the leading risk modeling tool, "value at risk" or VaR, which provides a "worst case" estimate of the risk in a portfolio. I mentioned that in the first nine years after the model was adopted, its predicted maximum trading loss was never exceeded. And then, in the third quarter of 2007, it was exceeded on a quarter of the trading days. So clearly, this model proved to be less than totally reliable. The model may be flawed, the historic data on which it was based may have been non-representative or insufficient, or the world may have changed. Regardless of the reason, VaR failed.

When you read about Goldman Sachs's success in avoiding the CDO turmoil and getting net-short, (see *The Wall Street Journal* of December 14), you see it was done on the basis of the reasoned judgment of executives on its proprietary trading desk. Ironically, when mortgage-related security prices first began to plummet, the increase in volatility raised Goldman's VaR, causing the elimination of positions that eventually would have been highly profitable. According to the *WSJ*, "a client who had similar positions at the time . . . says he made \$100 million by relieving Goldman of [a] short bet. 'It appeared to me that [the traders] constantly fought a VaR battle with the firm once the market started to

break.” But in the end, subjective judgment was permitted to override risk management science, with great results.

Interestingly, many banks got into trouble because their top executives wanted to “be like Goldman” and demanded that more be bet for the house’s account. But they lacked people capable of correctly making the needed judgments and relied instead on statistical risk managers. They’ve lost a lot of money, and a lot of the executives and the risk managers are out of a job.

Enough with the Quants Already

Over the forty years since I attended grad school at the University of Chicago – largely inspired by theories originated there – there’s been a pronounced rise in the participation of “quants” in the investment business. These are people who know a lot about statistics and computer modeling. They specialize in manipulating large amounts of data and predicting how portfolios are likely to perform under a variety of scenarios. But usually they don’t know much about the individual securities that make up the portfolios . . . or feel the need to do so. **In other words, you might say they know the price of everything and the value of nothing.**

In recent years – and in the excesses we’re examining – the ranks of quants grew to include the risk managers discussed just above; “financial engineers” at investment banks who structured complex entities and simulated their future performance; analysts at monoline insurers who assessed the risks they were asked to insure; and people who managed portfolios, usually hedge funds, on the basis of mathematical algorithms.

However, it should be noted that **quants and their computer models primarily extrapolate the patterns that have held true in past markets. They can’t predict changes in those patterns; they can’t anticipate aberrant periods; and thus they generally overestimate the reliability of past norms.**

To give you a context in which to think about that, I’ll again borrow some wisdom from my friend Ric Kayne: **“99% of financial history has taken place within two standard deviations,” he says, “but everything interesting has taken place outside of two standard deviations.”** In other words, most of the time markets follow their normal patterns, and when they do, assets are priced reasonably and there isn’t much to do. But on rare occasion, the markets go off the rails, and that’s when big money is made and lost.

Now think about the quants. They know all about how things will work if times are normal, but their analysis is of no help when events occur that reside in the far-off, improbable tails of the probability distribution – like when it turns out that 2% isn’t the right default rate for subprime mortgages, and the actual figure is several times that.

One of the great investment books of the 1960s was *The Money Game* by the pseudonymous Adam Smith. Smith talked about a veteran investor, the Great Winfield, who knew he was falling behind the times but had the answer: “Our trouble is that we are too old for this market. . . . My solution to the current market: kids.” In the last decade or two, everyone hired quantitative whiz kids, and the results were disastrous.

Hopefully, the events of the last few years will produce a sea change, in which investors come to rely more on seasoned judgment and less on financial engineers.

Greenspan and the Fed

Alan Greenspan deserves a lot of credit for presiding over one of the greatest periods of prosperity and market gains in our history, and for saying, presciently, “. . . history has not dealt kindly with the aftermath of protracted periods of low risk premiums.” With apologies to my indirect personal connection to the ex-Fed Chairman, I must express my view that his stewardship wasn’t perfect. (Of course, I doubt he’d say it was perfect.)

- Because he rarely used his bully pulpit to warn about excesses, advances were permitted to run unchecked. For example, his warning against “irrational exuberance” attracted a lot of attention, but I’ve always wondered why, if he considered it justified in 1996 with the Dow at 6,400, we heard nothing from him on the subject in 2000, when it topped out at 11,700. And mightn’t he have warned in recent years about overheated home prices and aggressive mortgage lending tactics?
- He did little to “remove the punchbowl,” or puncture bubbles. He could have pushed for higher margin requirements in 1998-99, or for mortgage reforms in 2004 or 2005, but he didn’t, insisting that it’s difficult to identify bubbles other than in hindsight.
- He was too much of a cheerleader, providing justification for market advances, often on the basis of productivity gains.
- In 2004, he urged people to take out adjustable rate mortgages rather than fixed-rate loans, since they always carry the lowest initial interest rate. But he overlooked the fact that (a) low-income borrowers might be ill-equipped to handle the risk of resets to higher rates, and (b) with mortgage rates at multi-generational lows, that would have been a great time for them to fix their interest cost. Just think where we’d be if a good portion of today’s adjustable-rate mortgages carried fixed rates instead.
- **Having cut interest rates to head off negative ramifications from the bumps in the road, he left them low for too long. I learned in the hyperinflationary late 1970s and early ’80s that when people feel an asset will always appreciate at an annual rate in excess of the cost of money, the result is speculative demand. That certainly was the case this decade.**

In general, it seems the Fed – including the current Bernanke regime – wants to let advances run and limit declines, whether in the economy or the markets. Everyone wants

advances and no one – except bargain hunters and investors in distress – relishes pullbacks. But I wonder if that stance makes sense.

How can we have gains but not losses? How can a free-market economy allocate capital effectively if capital creation is abetted and capital destruction is prevented? The fact is, excesses like we've just seen have to be corrected – painfully – and if they aren't, they'll just grow bigger and bigger as the cycles wear on. "Moral hazard" will arise, convincing people that risk takers will always be bailed out, something that's bound to encourage greater risk taking.

The Fed's actions in the current situation have been dramatic:

- an unexpectedly large half-point cut in the discount rate in September,
- strong steps to inject liquidity and encourage borrowing by banks, and
- an unusual $\frac{3}{4}$ -point rate cut on January 21, followed by another $\frac{1}{2}$ point a week later.

In two decades as Fed Chairman, Alan Greenspan was required to deal with the emerging market crisis and meltdown of Long Term Capital Management in 1998; the possibility of a Y2K glitch; the tech stock and broader bear market in 2000-02; the ramifications of the 9/11 attack; and concern over the possibility of deflation. **And yet he never cut rates by $\frac{3}{4}$ point in one step or by $1\frac{1}{4}$ points in just eight days.** Thus Bernanke's actions seem extreme. Is the Fed attempting to prevent a normal recession? Does it foresee an unusually serious one, perhaps driven by unprecedented weakness in home prices? Or is it concerned about profound financial system weakness, centered at banks and the monoline insurers?

Kudos and Brickbats

I hesitate to single out an individual for criticism, especially after he's been punished through loss of his job, but CEO **Chuck Prince of Citigroup** contributed the unfortunate quote that just has to stand as the symbol of the last few years' excesses. In early July, he showed foresight by saying "when the music stops, in terms of liquidity, things will get complicated." Unfortunately, he added, **"as long as the music is playing, you've got to get up and dance. We're still dancing."**

What I think Prince was saying is that even if the market's overheated, a financial institution has to participate or risk losing market share to those who will. But that's my point. **Is there any business a company won't do? Is there any profit a company won't pursue? Might there be something worse than losing market share?** What a wonderful thing it would have been to lose market share in the crazy period leading up to last summer. Doing so held the key to avoiding the CDO carnage. **Short-termism is one of the greatest problems in U.S. business today, and it makes it tough to go left when all your competitors are going right. But our business leaders should dare to be great.**

Bank of America CEO Ken Lewis won my respect early last year when he said, “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.” He was dead right. The question is what he did about it. B of A took a \$5.4 billion write-down in the fourth quarter and has \$12 billion of CDO exposure left. Those numbers are about a third of Citigroup’s. Is that good or bad?

Who else saw what was coming?

- **Jim Grant** was very outspoken about CDO excesses in his newsletter, “Grant’s Interest Rate Observer,” and early enough for heedful investors to have done something about it. He was one of the first, for example, to question the fact that most of the collateral behind CDOs was rated below investment grade, and yet a vast majority of CDO debt was rated above investment grade.
- **William Conway** of Carlyle Group attracted a lot of attention – but perhaps not all he deserved – for a January 2007 memo to his Carlyle colleagues, in which he wrote:

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. . . . 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 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.

- **John Paulson** won well-deserved fame for generating returns up to 590% in his hedge funds last year. He did three things well: He recognized the excesses in the residential real estate arena. He figured out how to profit from their inevitable reversal. And he was lucky enough to get the timing right; rather than reach his conclusion earlier, look wrong for a long time and give up – as others did – he turned bearish in 2005 and was able to hold on until events began to prove him right in 2006.
- I’m glad to say **our clients’ sectors of the investment world** – such as pension and endowment funds and insurance companies – generally haven’t reported much participation in the most highly leveraged entities.
- **Goldman Sachs** has distinguished itself thus far by avoiding subprime and CDO losses, being short mortgage paper and skating through the crisis. **Lehman Brothers, Credit Suisse, Deutsche Bank** and **JP Morgan Chase** are other institutions that seem to have signed on for less subprime pain than their competitors.

Finally, a statement by the Chief Executive of **UBS** provided another insight into the recent events. Early last December, he said, “the ultimate value of our subprime holdings . . . remains unknowable.” I admire his candor, and I’m sure he’s right. But the question I’m left with is whether it might have been possible for buyers of subprime-related paper to reach that realization at the time they first evaluated those assets?

Where Does the Buck Stop?

In affixing ultimate responsibility for losing investments, I tend to look to the investors who made them. Sometimes investors are blind-sided by unforeseeable events, and sometimes they’re preyed upon by unethical or even criminal purveyors. **But usually the process couldn’t have gone as far as it did if it wasn’t for buyers who sought return too avidly, trusted too much, failed in some way to be alert to the potential for loss, and fell for something that was too good to be true.**

Everyone dreams of return without high risk. But where can it be found? Not in markets that are working properly – that is, markets that are efficient. Not in leverage, which should be expected to cut both ways, magnifying both risk as well as return. Not in doing what everyone else is doing, or in buying the product *du jour* that’s being touted broadly and purchased unquestioningly. At best it can be found, with regard to markets that are less than fully efficient, in possessing – or aligning yourself with investors who possess – that scarce attribute: personal skill . . . superior insight . . . alpha.

To fully understand how superior returns are achieved and why they’re rare, you have to grasp the concept of “excess return.” It’s what everyone wants. It’s “superior risk-adjusted return”: the amount by which an active investor’s return exceeds that which can be achieved through a passive portfolio of the same riskiness. **For active investing to work and for excess return to exist, market participants – and thus, collectively, the market – have to be making mistakes. That’s how I think of the thing called “market inefficiency.”** Thus, people who think excess return is readily available fail to ask a few simple questions:

- Why should a free lunch exist despite the presence of thousands of investors who’re ready and willing to bid up the price of anything that’s too cheap?
- Why is the seller of the asset willing to part with it at a price from which it’ll give me an excessive return? Do I really know more about the asset than he does?
- If it’s such a great proposition, why hasn’t someone else snapped it up?
- Why is the broker offering it to me (rather than grabbing it for his prop desk)?
- **And if the return appears so generous in proportion to the risk, might I be overlooking some hidden risk?**

How do the CDO buyers measure up in this regard? I’d guess they were told they could get better returns from a double-A mortgage security than a double-A corporate without any incremental risk (or else leveraging up wouldn’t have seemed so safe). I believe they were told the source of this return would be the market, as opposed to great skill on the

part of CDO managers. I imagine they relied heavily on the participation of the rating agencies and monoline insurers. Each of these was flawed.

What made them believe that mortgage loans could be bought up and packaged into CDO securities (with multiple fees paid along the way) with the resulting return still excessive? Why should one legitimate double-A significantly out-yield another? Why didn't they ask more about the process through which this miracle was being accomplished? Why did they accept that narrow spreads could safely be turned into generous returns through leverage? Why did they trust so heavily in the simulated performance of securities for which the existing track record wasn't applicable? Did they look into the motivation and capabilities of the rating agencies and insurers on which they depended? **In short, were they skeptical enough?**

Many CDO buyers had no independent ability to assess the risks of CDOs. But they bought anyway. They followed their desire for high risk-adjusted returns, took action based on the relationship between promised return and rating, and went astray.

The bottom line of all of this is that one of the main functions of markets is to drive out excess return by bringing buyers and sellers together at prices from which the return will be just fair. Realizing that makes skepticism an indispensable ingredient in superior investing. Most investment failures are preceded by a dearth of it.

* * *

I often think back to an early 1990s issue of *Forbes* on the subject of compensation. It quoted an experienced corporate director as saying something like, "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."

It's clear that in recent years, improper incentives caused a lot of people to do the wrong thing. Loan originators with nothing riding on the loans' long-term performance. Investment bankers who expected to package and resell loans before they went bad. Rating agencies and appraisers – the investor's protectors – incentivized to come in high. Companies that (a) were lured by potential profit into areas where there was no way to understand what would happen in tough times, and thus (b) accepted risks for which they were unprepared. Financial institutions that failed to sit out when the markets became overheated.

My wife Nancy says she likes this memo more than most, because the lesson is so easy to understand. **"People can't be counted on to do the right thing," she said, "when they don't have anything at risk."**

Far more participants in this process covered themselves with dishonor than with distinction, as attested to by the magnitude and ubiquitousness of the losses. But the

blame for the current problems falls primarily on two groups, and there's nothing new about either:

- middlemen who were improperly motivated by the ability to profit from actions for which they wouldn't remain responsible, and
- buyers who believed too readily that return was available without proportionate risk and thus were willing to buy things they didn't understand.

Errors in process, judgment and character like those of the last few years cannot be kept from occurring. All any of us can do is try to avoid joining in.

February 20, 2008

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Memo to: Oaktree Clients
From: Howard Marks
Re: The Tide Goes Out

For every period, there's a quotation which serves perfectly to explain what's going on, and I often find myself borrowing it. Warren Buffett provides more than his share; not only is his insight unmatched, but so is his ability to express it. Thus, starting with "It's All Good" last July, I've found frequent use for this one:

When the tide goes out, we find out who's been swimming without a bathing suit.

Certainly, "swimming without a bathing suit" – or perhaps a life preserver – serves beautifully to describe investor behavior during the carefree period that ended last summer. And equally, the ebbing of the tide – and the exposing of those who engaged in that behavior – sums up the unpleasant disclosures which have taken place since. Financial sector participants indulged in unprecedented amounts of leverage, innovation and risk taking between late 2002 and mid-2007, the consequences of which have become readily apparent.

Leveraging and Inflating

When we look at the last few years, we see a rather ordinary period of economic growth and prosperity, accompanied by good corporate health and profitability. **But what distinguished this period from all others was a runaway boom in financial sector activity.** The whole financial sector inflated, like a balloon into which increasingly more hot air was forced.

The greatest contributor to the 2002-07 boom likely was leverage; the recent past saw a steady flow of equity capital to levered entities, accompanied by willingness on the part of lenders to provide unprecedented amounts of leverage. Now the reversal of that process is underway, with consequences that are equally dramatic but much less pleasant.

Let's review the process which was often described and embraced as a virtuous circle:

- Equity capital was provided to would-be leveraged entities.
- Debt was readily available for them to use in expanding their total capital and thus their ability to pursue profit.
- This combined capital was used to purchase assets, forcing prices higher.
- Price appreciation caused the entities' equity to expand at a faster rate thanks to their financial leverage.

- The increases in equity were matched by further increases in borrowings.
- In fact, the good performance convinced lenders to increase the amount of leverage they would supply per dollar of equity. This meant the entities could grow their portfolios even faster than the rates at which equity capital flowed in and assets appreciated.
- Further, because of the seeming impregnability of the leveraged entities' profitability, risk aversion shrank and the risk premiums and returns demanded by lenders declined. Leverage became cheaper and thus even more attractive.
- As is typical of virtuous circles, everything ran smoothly . . . for a while: additional equity flowed in; it was leveraged up increasingly; buying caused assets to appreciate further; and the upward spiral continued.

With things working increasingly well and investors becoming more and more excited, processes like this one seem destined to go on forever. Of course, they cannot. But people forget that, satisfying one of the key prerequisites for a cycle that goes to excess. Overestimating the longevity of up legs and down legs is one of the mistakes that investors insist on repeating.

Deleveraging and Deflating

Over the years I've written a number of memos about cycles, and in each one I've tried to remind readers that trees don't grow to the sky, and that success carries within itself the seeds of failure. Just as the balloon of levered entities expanded beyond reason in the last few years, now it's well into the process of deflating. And, as I mentioned in "Now What?" the air always goes out a lot faster than it went in.

Eventually, developments that are exogenous to the process interfere, or perhaps the process collapses of its own weight. In the current instance, consider subprime mortgages. The process described above was going along just fine, with increasing numbers of ever-larger mortgages being granted to cover a rising percentage of the cost of houses bought at rising prices by borrowers of declining creditworthiness. So far, so good: a process unhampered by discipline or restraint. But it must be seen that, eventually, reality will intrude. For example, eventually the amounts borrowed will necessitate payments that exceed what the borrowers can afford. **Oops; investors forgot that part.**

To understand what's going on now, all you have to do is reverse the process described above and squeeze (the squeeze – the force behind the deflating – comes from the pain that accompanies disclosure of the process's flaws).

- Something causes asset prices to weaken.
- Now the leverage works in reverse, causing the entities' equity to shrink faster than the rate of decline in asset prices, and their ratios of borrowings to assets to rise.
- Lenders, worried about declining asset prices, either call in their loans or refuse to roll over debt when it matures. In some cases, the entities' now-shrunken collateral fails a

- Further, with the world suddenly feeling much riskier, lenders demand increased risk premiums, raising the cost of borrowed funds and further impairing borrowers' economics.
- Equity investors – panicked by the combination of asset price declines, leveraged equity losses and margin calls – withdraw equity capital to the extent they can. The sight of investors lining up at the withdrawal window, and often being told they can't have their money, adds to the negative climate.
- The need to raise cash with which to satisfy the demands of lenders and equity investors places further downward pressure on asset prices, reinforcing what is suddenly a vicious circle. Fire sales of collateral add to this pressure.
- In particular, think what happens to banks. In this negative environment, it's hard to imagine these highly leveraged entities extending credit, given that (a) banks' equity is shrinking, (b) they feel they may need the money themselves, and (c) they fear further losses on loans and assets.

It shouldn't come as a surprise that this vicious circle seems as obvious and inescapable as did the virtuous one just a short time earlier. This is the point at which we may start to hear talk about the unstoppable downward spiral and thus the pending collapse of the financial system. **Unquestioning euphoria gives way to full-blown depression.**

Mark-to-Market Accounting

If you watch enough cop shows on TV, you know that investigators of suspicious fires use the term "accelerant" for the chemical used by an arsonist to encourage the spread of a blaze. The current capital market cycle has been accelerated by an element that was added to the capital market equation in the 1990s: mark-to-market accounting.

In the simpler but still not totally stable financial world I entered forty years ago, stability was desired in financial institutions. So, for example, banks and insurance companies were allowed to carry a loan or a bond at cost on their balance sheets as long as it was (a) fundamentally unimpaired and (b) intended to be held to maturity. Even if its market value fell temporarily, it was assumed that a creditworthy claim would be repaid in full at maturity. Thus, price fluctuations were ignored as long as fundamentals were sound.

More recently, "transparency," "accountability" and "market signals" became more highly prized. A lot of this had to do with skullduggery unearthed at companies like Enron. As a result, accounting increasingly came to require that assets be valued at actual or estimated market prices. I'd had a preview of this in 1990 when, as part of efforts to "get" the high yield bond industry (and Drexel and Milken), S&Ls were required to market price their holdings of high yield bonds – dooming many of them in a time of price weakness.

There is no perfect accounting standard – just choices, with each alternative stronger on some desired traits but weaker on others. “Cost” is objective but often out of date and far from accurate. “Lower-of-cost-or-market” is conservative but asymmetrical in its error. “Market value” is contemporary but not always reliable; it discloses value declines faster than Enron did, but it also requires subjective judgments and bakes in price fluctuations that may prove transitory. **So when accounting regulators mandated mark-to-market, they decided in favor of currentness and transparency but against stability with regard to marketable securities and objectiveness with regard to privates.**

(When we began to organize closed-end funds in 1988, and for about fifteen years thereafter, Bruce and I established a policy for valuing privates based on “cost unless there’s been a change which is fundamental, material and permanent.” We felt it served us well. But since Enron and Sarbanes-Oxley, we’ve been forbidden to use that approach. Now funds are required to price each asset based on opinions regarding its worth. We preferred the old way. Who’s better served now?)

Mark-to-market accounting turns out to be one of the main contributors to the current boom/bust cycle. In the old days, a bank (for example) would have carried assets at cost. In this decade’s up years, since that bank was required to mark them to market, it was able to expand its balance sheet, and thus its operations, as assets appreciated in the virtuous circle. Equally, contracting asset values now mean the bank’s portfolio is worth less, and that its equity is smaller and can support less debt and thus less lending. Loan portfolios have to be reduced, and new loans can’t be made. A bank’s regulatory capital can become insufficient; it’s this, in part, that has been behind the banks’ trips to sovereign wealth funds for re-equitization.

Since they operate in a world that combines rigid regulatory capital requirements, high leverage, fluctuating asset prices and, now, mark-to-market accounting, financial institutions can fail to be viable in extreme bear markets. (And as *The Wall Street Journal* of March 6 said, “What’s the difference between a hedge fund and a bank? Banks are more highly leveraged.”)

In 1990, when high yield bonds had the brush with difficulty described above (meaning spreads widened to 1,100 basis points, and a law was passed that required S&Ls to reflect price declines on their balance sheets), I was asked to brief the board of TCW on the risks. I presented a parable about a regulated financial institution that went bankrupt under the weight of mark-to-market accounting. I joked with Bill Spencer, who was president of Citibank when I worked there, that in the 1980s, that could have been Citibank if it was required to recognize mark-to-market losses on real estate loans. **Guess what: today that’s the rule.**

This raises one of my favorite questions: **what’s an asset’s price?**

- Is it what you could get for it if you wanted to sell it?
- Is it what you would have to pay to buy it?
- Is it the price to buy or sell \$1 million worth, or \$100 million worth?

- Is it the likely proceeds from the patient sale of an asset in isolation, or what you'd get for it as part of a large portfolio that has to be liquidated in one day?
- Is it the price in today's chaotic market, or what the price would be in a calmer one? And if the latter, who says what that is?
- Is it Goldman's price or Morgan's? Or the average of the two? And what if you find out that Lehman's is lower than both of them?
- What's the price if the asset doesn't trade? Or if you hold the whole thing and have no intention to sell?

I don't have the answer. Mainly because there is no answer. In short, an asset doesn't have "a price." It has many possible prices, and no one can say which is the right one. The ads for a jeweler here in Los Angeles lead with a great headline: "guaranteed to appraise for more." In other words, either (a) he sells jewelry for less than it's worth (and, if so, why?), or (b) he sells things for what they're worth but guarantees they'll appraise for more, which makes you wonder about the appraisals. The way I see it, the appraisals he touts are just as meaningless as many of the "market prices" being used today to price assets at banks, hedge funds, CDOs and CLOs.

A view has begun to be expressed that mark-to-market accounting – in conjunction with the vicious circle that prevails today – is causing asset values to be understated, writeoffs to be overstated, and the credit crisis to be exaggerated. Certainly there's every reason to believe that:

- Assets are being valued based on what people will pay for them (which is the goal), but with few people in a buying mood, market prices can far understate value.
- Supply and demand have completely supplanted fundamentals in determining prices.
- With little trading taking place, assets are often priced via reference to indices. But those indices fluctuate wildly in connection with speculation and hedging activity, and they may have little relevance to the individual asset being priced.
- Lenders are switching their valuations of collateral from going concern basis to liquidation basis.
- Margin calls are resulting in liquidations, which depress prices, leading to more margin calls.

It's hard to believe these are really the bases on which financial institutions should value their trillion-dollar balance sheets. But we're stuck for now with mark-to-market accounting. At minimum, you should expect it to contribute extensively to continued volatility. Believe me, it already has.

"Should" ≠ "Will"

Lately I've enjoyed comparisons of recent developments to Frankenstein's loss of control over his monster, or to a man-made mutation that has escaped from the laboratory. Extensive financial sector experimentation took place involving unprecedented combinations of volatile elements such as leverage, securitization, tranching, derivatives

and mark-to-market accounting. In the lab, experimental microbes would be quarantined until their dangers were fully understood. In the financial markets of this decade, on the other hand, they were rapidly popularized and peddled world-wide.

In 1998, Long-Term Capital Management became the poster child for the ability of sophisticated investment strategies to malfunction with grave consequences. This hedge fund invested in a highly diverse portfolio of fixed income arbitrage positions. These were situations where two related assets were trading in violation of their normal price relationship: one was a little more expensive relative to the other than history said it should be. LTCM bought into these small mispricings in large quantities, on enormous leverage, in the expectation that they would correct. The explanation for its subsequent meltdown was simple, according to the founder, John Meriwether: “The Fund added to its positions in anticipation of convergence, yet . . . the trades diverged dramatically.”

For years these memos have quoted my good friend, Bruce Newberg, as saying, “Improbable things happen all the time, and things that are supposed to happen often fail to do so.” Acting in excessive reliance on the fact that something “should happen” can kill you when it doesn’t. That’s why I always remind people about the 6-foot-tall man who drowned crossing the stream that was 5 feet deep on average. You have to be able to get through the low points. And the success of your investment actions shouldn’t depend on normal outcomes prevailing; instead, you must allow for outliers.

Recent tales from the bust include a number of disasters that arose because things didn’t work as they were supposed to:

- Although defaults **should** be independent, subprime-related securities collapsed when mortgage borrowers all over the country began to default at the same time.
- Auction rate notes should have delivered the benefits of both long-term financing (permanence) and short-term financing (low rates), because frequent rate resets **should have** eliminated the price risk that accompanies fixed-rate long-term debt holdings. But the reset process failed to work when the auctions attracted no bidders.
- At the top in commercial real estate during the second quarter of 2007, real estate investors were willing to buy New York office buildings at 3½% cash yields (with money borrowed at 5½%) because (a) rents **should** double to \$150 sq. ft./year or, anyway, (b) someone else **should** be willing to pay more for it. So far . . . no.
- “Absolute return funds” **should** provide steady returns without vulnerability to market fluctuations. It turned out, however, that only completely hedged vehicles are completely without market correlation, and now a good absolute return fund may be one that goes down only half as much.
- A London hedge fund called Peloton gained 87% in 2007 and was named Credit Hedge Fund of the Year in January. Its long positions in AAA mortgage paper **should have** continued to hold up better than its subprime shorts. But the AAAs declined this year, and they’d bought enough on leverage to make the fund melt down in February.
- Credit default swaps **should** serve as a great way to transfer credit risk. But the market grew out of control – to \$40-odd trillion of insurance coverage on \$6 trillion

Clearly, investors only make investments because they expect them to work out, and their analysis will center on the likely scenarios. But they mustn't fixate on that which is supposed to happen to the exclusion of the other possibilities . . . and load up on risk and leverage to the point where negative outcomes will do them in.

At the same time, however, it's very hard to figure out how broad the range of considered possibilities should be. No investment action can withstand every possible development. Is there really such a thing as a "worst case assumption" short of a total loss? I often find myself asking one of the classic questions in investing: **How much effort and capital should we devote to preparing for the improbable disaster?**

Many of the recent problems occurred because investors expected outcomes other than the ones that arose. Had they been too optimistic? Or did the environment simply throw curves that no one should have been expected to handle?

Leverage and Risk

Two important investment principles should be embraced concerning leverage and risk:

First, leverage magnifies outcomes but doesn't add value. I've said that so often that I ought to stop. But just a few reminders:

- Leverage magnifies losses as well as gains. In Las Vegas, they say, "The more you bet, the more you win when you win." But they always forget to add ". . . and the more you lose when you lose." **Leverage is just a way to bet more.**
- Leverage magnifies outcomes but doesn't add value. It will make for higher highs and lower lows, and it might even produce an increase in the expected value . . . assuming outcomes are normal. But it can't make something a fundamentally better investment. **Thus, leverage absolutely cannot be equated to the contribution to return that comes from skill in selecting investments or in restructuring company operations or finances.**
- From time to time, people come up with structures that are purported to add to an investment's upside without adding proportionally to its downside. They rarely work. Or, expressed properly, **it makes no sense to expect them to enhance the expected return without increasing the range of outcomes and the risk of loss.** You may be able to take an investment with a 10% promised return and turn it into a vehicle that has a 90% chance of earning 13% and a 10% chance of losing everything. **But can**

- Finally, in addition to magnifying losses as well as gains, **leverage carries an extra risk on the downside that isn't offset by accompanying upside: the risk of ruin.** Leverage, when added to losses, can lead to margin calls and meltdowns. There is no corresponding benefit. This lesson is being well learned today.

Second, every investment or portfolio entails a variety of risks, and its overall risk is the sum of those.

Every investment embodies both the specific risk related to the individual company or asset and the systematic risk that is a function of its membership in a market – its beta. There also can be liquidity risk, legal risk, currency risk and political risk. Finally, risk is introduced by the structure in which an asset is held. Here I'm referring to the risk that comes with leverage.

To simplify for my current purpose, risk comes from the combination of what you buy and how you finance it. You can buy very risky assets, but if you don't lever up to do so, you'll never lose them to a margin call. Or you can buy fundamentally safe assets, but the combination of enough leverage and a sufficiently hostile environment can cause a meltdown. **In other words, investing in "safe" assets isn't necessarily safe, particularly if you've borrowed to buy them.**

We've seen this at work in recent days, as entities that invested in top-quality assets have run into trouble. For example, Carlyle Capital Corp. ("CCC") invested in AAA-rated debt of the two government-sponsored housing agencies, Freddie Mac and Fannie Mae. But it levered its equity 31 times to do so, buying \$21.7 billion of securities on the basis of just \$670 million of equity. That meant that if values declined 3%, its equity would be gone. Worried bankers pulled back their loans; CCC received margin calls it couldn't meet; the banks seized its assets; and the fund melted down.

Investment safety doesn't come from doing safe things, but from doing things safely. Put another way, anything can be screwed up by using so much leverage that its fluctuations can't be survived. That's why, in writing about LTCM in "Genius Isn't Enough" (January 1999), I said **leverage + volatility = dynamite.**

Financial Self-Destruction

The dramatic cyclical up leg of nearly five years (I'd say November 2002 through June 2007), as well as the far shorter but equally dramatic down leg that started last summer, have given me opportunity to reflect on a number of phenomena to be noted and lessons to be learned. You've seen the results in the last three memos ("No Different This Time," "Now What?" and "Whodunit"). I've reached a new view of how some things work, based on tying together several separate observations.

- **I've pointed out that one of the reasons models can fail to work is because markets are dynamic, not static.** Through frequent play, you can increase your mastery over a golf course, as you learn the consequences of each action and thus which are the right ones: if you hit the ball to spot A it'll roll toward the hole, whereas if you hit to spot B it'll roll toward the water. Eventual mastery is possible because the golf course doesn't change in response to your play. But fixing on tactics through which to master a market is unavailing, because the market is shaped by those who participate in it, and thus it responds and changes. No course of investment action – even if executed perfectly – can be right for all markets and all times. **In fact, when an approach becomes too well accepted, the widespread reliance on it becomes a source of danger.**
- I've devoted a lot of ink to Wall Street's innovation of financial products. Innovation becomes possible in up markets, when optimistic investors:
 - think about what might work and dismiss the likelihood of failure,
 - are willing to give something new the benefit of the doubt,
 - are impressed by early, easy successes, and
 - fear the consequences of failing to emulate competitors who enjoy those successes.

In the last five years, these factors abetted unprecedented financial innovation, as quants assured prospective investors that the “fat-tail” events that could cause the new products to fail were most unlikely to occur.

- **But while the quants' predictions usually center on the high probability that events will fall within the normal range, the last nine months have given all of us the opportunity to witness events at the extreme.** This started last summer, when “once-in-a-lifetime events” became common. David Viniar, CFO of Goldman Sachs, may be remembered for saying in August that “we were seeing things that were 25-standard deviation moves, several days in a row.” It's unusual for 100-year floods to become daily occurrences, but sometimes they do.
- **Finally, I've reminded readers about past bull market innovations that promised miracles but often failed when tested in bear markets.** One of the most easily recognized of these is “portfolio insurance.” PI was a statistically derived technique that would enable equity exposure to be increased without a commensurate increase in risk. This was made possible by a process through which computer-generated sell orders would be implemented automatically in the event of a market decline, instantaneously scaling back portfolio risk. PI had its heyday in the period just before “Black Monday.” But then, on October 19, 1987, the U.S. stock market declined 20%; beleaguered brokers didn't answer their phones; the sell orders weren't implemented; and PI ceased to be heard of.

A few months ago, the twentieth anniversary of Black Monday gave me the opportunity to reflect on the short life of portfolio insurance. **I began to think – and now I’m convinced – that PI didn’t fail because Black Monday just happened to occur. Rather, it contributed to Black Monday’s occurrence, and thus to its own demise.**

In my December memo “No Different This Time” I listed twelve lessons of 2007. Number four said that “widespread disregard for risk creates great risk.” **In that way, in 1987 the widespread belief that equity exposure could be increased without similarly increasing risk led to an unjustified – and unsustainable – expansion of equity allocations. And the carefree buying this generated led to elevated stock prices from which a retreat was increasingly likely.** When the S&P 500 fell 10% on the Wednesday-Friday leading up to Black Monday and users of PI had the weekend to think things over, it seems they concluded that they had accepted too much risk; that they couldn’t depend on PI to save them; and that they had to dump stocks en masse. **Thus, this innovation was not undone by a chance event. Its undoing was brought about by an event which it had, at least in part, caused.**

Innovation generally requires bullish assumptions, and thus it’s easily accomplished in bullish times. Those optimistic assumptions add to the risk in the environment, and when eventually proved to be too rosy, they contribute to losses and to the products’ failure. **The naked swimming which is encouraged by the rising tide certainly is exposed when the tide goes out. But I’d go further: in the dynamic environment of the marketplace, naked swimming eventually can cause the tide to go out.**

A New Kind of Crisis

People ask me whether things look familiar, and how this cycle compares to others I’ve experienced. I tell them this one’s different in both degree and kind.

We’ve had collapses in the past, but never so broad-gauged and systemic. The earlier ones were the result of things going on in specific sectors or regions: LBO debt in 1990, real estate in 1992-94, emerging markets in 1997-98, and tech/telecom stocks in 2000-02. Most people would prefer to see the weakness centered in specific areas . . . and thus containable, treatable and avoidable.

This bust isn’t sector-based, although it was ignited first in subprime mortgages. Instead, it stems from the broad application of the techniques I’ve been discussing: leverage, securitization, tranching and derivatives. Because Wall Street applied those techniques in so many ways, the current problems are generalized and pervasive and have the ability to cause losses in a wide variety of areas, irrespective of the underlying fundamentals.

The current bust arose against a backdrop of healthy fundamentals. The economy was growing. Commercial real estate wasn’t overbuilt. Bond defaults were at record lows. Yet huge markdowns have taken place in these areas. Thus the solution will not come

from addressing localized fundamental problems. Instead, the problem is hydra-headed, affecting a large number of areas due to contagion. Larry Summers put it this way:

You have three vicious cycles going on simultaneously. A liquidity vicious cycle -- in which asset prices fall, people sell and therefore prices fall more; a Keynesian vicious cycle -- where people's incomes go down, so they spend less, so other people's income falls and they spend less; and a credit accelerator, where economic losses cause financial problems that cause more real economy problems.

There is no schematic diagram for the workings of the economy and the markets, as in “if we do A, the result will be B.” That’s particularly true for the current crisis, since some of the financial techniques that gave rise to it are new; others haven’t been used to the same extent; and they’ve never been combined as they were in the last few years. **In particular, the workings of economies and markets depend heavily on psychology, which can’t be treated as if it’s hard-wired.** Thus the people trying to address this bust can only work from hypotheses and try possibilities.

The Fed and the administration are determined to solve the problem, but we’re unlikely to have the unwind we need without pain. As I wrote in “Whodunit,” in order for efficient capital allocation decisions to be made, an economic system that aims to create capital has to witness capital destruction from time to time. Efforts to avoid the pain would cause problems like unrecognized bad loans to linger, delaying a solution. **I’m no expert, but it makes sense to me that the quantum of pain on the way down has to at least approach the pleasure everyone felt during the boom.**

Other than just through the passage of time, the solution to the credit crunch – to the extent there is one – might be found in short-circuiting the deleveraging process described on pages 2 and 3. Thus, the authorities will try to get people to:

- face the music by recognizing and writing down problem assets,
- borrow money, even though the possible uses for it may seem ill-fated,
- make loans, despite the scarcity of capital and the risk of loss, and
- buy assets that are underpriced, even though prices seem only to go lower.

Interest rate cuts have made borrowing cheaper, and there will be more. Loans to banks will give them money they can turn around and lend. The government’s decision to let Fannie Mae and Freddie Mac make bigger loans should make capital available in the starved housing market. If necessary, a government backstop of the agencies would do even more (but it also would introduce moral hazard). A holiday from capital requirements would allow regulated financial institutions to take writeoffs and clear their balance sheets without having to worry about falling below minimums. They might even try suspending mark-to-market accounting.

The Fed's recent announcement that it will swap Treasury securities for AAA-rated mortgage debt that isn't trading well is such an attempt to stem the deleveraging process. If things go as the Fed hopes, this exchange should:

- take some mortgage paper out of circulation, improving the supply/demand balance and relieving the downward pressure on prices,
- make it more palatable to hold and buy mortgage paper and, especially, for dealers to maintain inventories and make markets in it,
- reduce yields, and thus the cost of money in the economy, and
- give institutions collateral against which they can borrow (and then lend).

The collapse of Bear Stearns, on the other hand, illustrates a few important limitations. Brokers, like other financial institutions, are highly leveraged entities. The nature of their assets makes it impossible for them to repay their liabilities on demand. Thus, none can survive a "run on the bank" stemming from a loss of confidence. As I said in "The Race to the Bottom," they all offer the same product – basically, money – and if confidence declines, nobody will say, "Okay, there's a 5% chance I'll lose my capital, or access to it for a while, but it's worth it because their product is so superior." **Who'll stay despite a decline in confidence? No one. And what financial institution absolutely can't be the subject of a loss of confidence? I'll let you answer that.**

Where Will It End?

When I was a kid, there were a lot of cartoons showing men carrying sandwich boards (who remembers what they were?) that said, "The end of the world is at hand." So far, though, they've been wrong. Likewise, people said we had approached the end of the financial system around Black Monday in 1987, and when LTCM melted down in 1998. But we're still here. It seems we muddle through, despite all attempts to screw things up. It's my guess we always will.

It's tempting for worriers like me to consider apocalyptic possibilities. But it's not productive, so I've quit. I can come up with "China Syndrome" theories, but (a) I can't give them a high probability of coming to pass, and (b) there's little I can do. **The things one would do to gird for the demise of the financial system will turn out to be huge mistakes if the outcome is anything else . . . and chances are high that it will be.**

* * *

Fortunately, one of the most valuable lessons of my career came in the early 1970s, when I learned about 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.

Buying during the first stage can be highly profitable, while buying during the last will carry you over the cliff with the rest of the herd.

Relatively few people were eager to buy at the depressed prices of 2002-03. But buying grew in 2004-05 as prices rose and bargains became scarcer, and the pace became fevered in 2006 and the first half of 2007. This trend was captured in the soaring amounts investors committed to U.S. buyout funds:

2002-03	\$ 52 billion
2004-05	200
2006-07	557

This growth in buyout capital was spurred on by high reported IRRs, which in turn were facilitated by dividend recaps and quick flips, themselves a symptom of the increasingly overheated capital market environment. **Had the high IRRs been the result of genuine investment skill or just well-timed risk taking?** So far we've learned a little about who swam naked – that is, for whom it was the latter rather than the former. We'll know for sure when the tide is fully out.

To aid in your consideration of the future, I've formulated the converse of the above, 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.

Certainly we're well into the second of these three stages. There's been lots of bad news and writeoffs. More and more people recognize the dangers inherent in things like innovation, leverage, derivatives, counterparty risk and mark-to-market accounting. And increasingly the problems seem insolvable.

One of these days, though, we'll reach the third stage, and the herd will give up on there being a solution. And unless the financial world really does end, we're likely to encounter the investment opportunities of a lifetime. **Major bottoms occur when everyone forgets that the tide also comes in. Those are the times we live for.**

March 18, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Aviary

Rather than dwell this time on a single subject, I want to cover a few. They may not seem related at first, but I believe they're birds of a feather.

A Dead Duck

While it's important that we have a sense for where we stand in terms of the market cycle, figuring that out can require some sophisticated inference. It's not often that we get crystal clear evidence of the pendulum's swing, or get it in short order. That's what makes the case I'll describe so distinctive.

"The Race to the Bottom" (February 2007) is one of my favorite memos. I think it presented clear evidence of the degree to which the pendulum of innovation and risk taking had swung to the undisciplined end of its arc. As I described, I was prompted to write it by an article in the Financial Times of November 1, 2006, which reported the following:

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.

After quoting that paragraph, I went on to draw what I thought was the compelling conclusion:

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.

Auctions were taking place in the capital markets, and suppliers of capital were bidding against each other to make deals. In the case of UK home mortgages, the right to make loans would go to the institution willing to lend the highest multiple of annual salary . . . that is, willing to accept the most risk. In the last few years, there were many ways in which lenders and investors vied for deal flow on the basis of lowered return expectations and heightened risk. I considered Abbey's decision emblematic of this trend.

Thus, you can imagine my reaction upon reading the following in the Financial Times of April 8:

First-time buyers with no cash savings were shut out of the housing market yesterday after Abbey became the last mainstream lender to stop offering 100 per cent mortgages. Borrowers who a month ago had a choice of mortgages offering 100 per cent of a property's value, will now need a deposit of at least 5 per cent . . . More than 20 lenders . . . offered 100 per cent mortgages at the start of last month. These have been pulled out of the market one by one as banks and building societies have distanced themselves from riskier lending.

Eighteen months ago, Abbey was the **first** to take lending standards to a new low in terms of times-salary-loaned. Now, it's the **last** to raise them with regard to down payments. Can there be a clearer example of the credit cycle at work?

For now, high-risk, no-worries lending seems to be a dead duck, a casualty of the corrections in risk aversion and demanded returns that have accompanied – or are at the root of – the current credit crunch. At the highs of the credit cycle, anyone can get money for any purpose. At the lows, even deserving borrowers are shut out. The former is highly expansionary, and the latter depresses economic activity. It'll always be so.

The Canard of Free Market Infallibility

“*Canard*” is the French word for “duck.” In English, however, a “canard” is “a false or unfounded report or story.” That English meaning comes from the French phrase “*vendre des canards à moitié*”: to cheat, literally, to half-sell ducks.

A canard gained broad acceptance over the last decade or two, as faith in the ability of the free market to optimally allocate assets morphed into an irrational expectation that the free market would produce a continually rising tide, lifting all boats and bringing a better life for everyone. Here's my version of the saga.

One of the longest cycles I've witnessed has taken place in the area of government involvement in the financial industry. Prior to 1929 (I wasn't around for this part), there was little regulation. When much of the subsequent market collapse was attributed to improper conduct in investment banking and in investments generally, this led to significant new regulation.

For an interesting look at behavior in the 1920s, I'd recommend *Wall Street Under Oath*, written in 1939 by Ferdinand Pecora, who led the Senate investigation into the causes of the Great Crash and then became a New York State judge. It's a scathing indictment: imagine Wall Street operating in the 1920s unhampered by today's securities laws. Among other things, the Street's conduct led to the enactment of the Glass-Steagall Act of 1933 that mandated the divorce of commercial banks from investment banks, the Securities Act of 1933 and the Securities Exchange Act of 1934. Thus a strong regulatory regime prevailed – particularly under the

Democrats who controlled the White House for 28 of the 36 years from 1933 to 1969, and the Senate for 44 of the 48 years from 1933 to 1981. (In America, regulation is generally associated with Democrats and liberalism, and deregulation with Republicans and conservatism.)

The last 28 years have been very different, however, thanks primarily to Ronald Reagan and Margaret Thatcher, bolstered by centrist Clinton and Blair administrations, and helped along by Bush, Bush and Brown. For much of that time, the Fed was under the leadership of Alan Greenspan, who is philosophically indebted to Ayn Rand, a strong believer in free markets.

Free-market solutions were deemed certain to yield optimal economic decisions. Deregulation, privatization and market pricing went into full swing. Government involvement in policy making and control was disrespected. In short, it was assumed that the profit motive – Adam Smith’s “invisible hand” – would maximize capital efficiency and, therefore, societal welfare.

This trend reached its apogee in the last ten years. The Glass-Steagall Act was nullified; this allowed, for example, the combination of Citibank and Salomon Brothers. Other than lowering interest rates and providing liquidity to fend off weakness, the Fed employed a hands-off approach. Investment managers and investment bankers gained fame and huge fees for performance that showed which of them were the most talented. In every corner, the cry was “let the market decide.”

Clearly, however, the events of recent years attest to excesses prompted by the profit motive. More was better: more leverage, more innovation, higher ratings for a given security and more activity in areas like residential real estate. **Equally clearly, not all of the free-market decisions were salutary; the proof can be found in the fact that *laissez-faire* has landed us in a financial crisis that some observers consider the potentially most serious since the Depression.**

How can we reconcile theory and practice: the way free-market decisions are supposed to work and the way they do work? The answer lies, I think, in the difference between short term and long, and in the coexistence of beneficial general trends and harmful exceptions. **Free markets allocate resources efficiently in the long run. But they can’t make the tide rise continually, and while some boats rise, others will crash. Properly functioning free markets will give rise to times that set the stage for ruin, and then to times of ruin itself. They must create losers as well as winners, and capital destruction as well as capital creation.**

In pursuit of profit in a free market, people can engage in any behavior that’s not illegal. (Well, actually, they can do illegal things too, but hopefully not for long.) Ethical considerations constrain some but not all, and ethicality seems to wax and wane. There’s no doubt that profit pursuers sometimes push the envelope. Examples?

- The fees for appraising houses and rating securities went to those willing to assign the highest values. Did they let this affect their valuations?

- Thanks to disintermediation, financial institutions saw that they could earn fees for originating loans and selling them onward. Did the rewards for achieving volume displace the prudence they used to employ when putting their own capital at risk?
- Once financial engineers had built their new tranching products, they could sell them at lower yields (higher prices), sell more of them, and earn bigger fees if they could get them rated higher. For a given instrument, single-A was good, double-A was better and triple-A was best. The investment bankers marshaled the data and fed it into their models, tweaked to yield the best possible result. **I find it hard to believe they ever said, “Wait a minute; triple-A’s too high given the underlying collateral” or “It can’t be triple-A, because there are a few scenarios that, although unlikely, would yield terrible results.”**

I’m not suggesting these people engaged in illegal activity or consciously did the wrong thing. They were just trying to make more money for their employers and themselves. But I believe their economic self-interest caused them to go to extremes in an environment that allowed candor, skepticism and ethics to be forgotten in pursuit of revenue maximization.

A New Canard Takes Flight

Government involvement in the private sector is like hemlines: it goes up and down. But it does so in very long cycles. It takes decades for it to reach maximums and minimums, and it can take a long time for the error of the extremes to be exposed.

In the last couple of months, we’ve read a great deal about the need for increased regulation, and there’ll be more. There are several reasons for this:

- First, when there’s a crisis, people tend to look for easy explanations. Insufficient regulation can be a good candidate.
- Members of the out-of-power political party can always make hay by blaming the governing party and its philosophy.
- **The truth is, whichever philosophy is in the ascendancy will deserve some responsibility for crises . . . because no approach is perfect. Regulation will always produce red tape and some inefficient, non-market solutions, and deregulation will always permit a degree of cowboy behavior.**
- It’s easy to allege that the solution can be found in reversing the trend in regulation, and hard to disprove *a priori*.

So now the cry has been raised. People are jumping on the bandwagon, and those opposed are trying to head it off with promises of better behavior and self-regulation. As the Financial Times noted on April 10,

Now credit and consumer confidence are ebbing, to the likely detriment of company profits. State intervention, which free marketers have argued against for centuries, has been royally legitimized.

Paul Volcker put it this way in the FT of April 12: “The bright new financial system – for all its talented participants, for all its rich rewards – has failed the test of the marketplace.” Belief in free market omniscience has been laid to rest for a while.

The New York Times of April 15 described Bob Steel, Treasury Under Secretary for Domestic Finance, as being highly optimistic about a “superregulator” or “market stability regulator” that “would pass judgment on the capital levels, trading exposure and leverage of Wall Street’s most sophisticated institutions.” Yet within just the last two years, it says, “Mr. Steel has been co-chairman of one commission that claimed heavy-handed regulation was stanching financial innovation and another that argued that hedge funds could police themselves.” Times certainly do change.

And in a sign of the times, *breakingviews.com*, an online interpreter of financial news, put it this way on May 14:

The hands-off approach to financial markets now looks neglectful. . . . Greenspan’s laissez-faire attitude to asset prices went along with paying little attention to bank supervision and positively welcoming the growth of less regulated financial institutions. Trusting financial markets to self-correct now looks wrongheaded. . . . **The authorities need to relearn that financial markets are too important and too impulsive to be left to operate unconstrained.** They work better with careful, consistent supervision. (Emphasis added)

In place of market-based decisions, we’re likely to see more limits on free-market activity. I find it impossible to believe that the government will do a better job than the market of allocating assets and preventing excesses. But the current pain – when combined with regulation’s avowed goals of avoiding harm, limiting predatory conduct and protecting the little guy – will make the trend hard to resist. As Martin Wolf wrote in the FT of April 16,

More regulation is on its way. After frightening politicians and policy makers so badly, even the most optimistic banker must realize this. **The question is whether the additional regulation will do any good.** (Emphasis added)

Some specific actions have the potential to increase financial security, such as (a) increases in the capital reserves required against complex structured products and off-balance-sheet vehicles and (b) full and detailed disclosure of the latter. Some increase in regulation seems appropriate, especially with regard to off-balance-sheet entities, the source of most of the banks’ losses. It’s remarkable that just six years after Enron, where the worst abuses were hidden off balance sheet, another crisis was able to arise there. Banks benefit from deposit insurance (the government’s seal of approval) and access to cheap Fed funds. Thus it’s reasonable that, in exchange, **all of their entities** should be tightly regulated. This is especially true since it’s been made clear that non-bank activities won’t be permitted to sink our large banks.

But I think there are dozens of reasons why generally increased regulation won't work to the hoped-for extent. Here are my first twelve:

1. **It's far easier to find holes in regulations than to plug them.** Financial professionals innovate and expand. Regulators must try to catch up, often with outdated tools. By the time new rules are enacted, the financiers have moved on to invent new products and open new loopholes.
2. It's a simple fact that the regulated are more financially motivated to act than the regulators are to respond. It's not without effect that investment bankers work two or three times as many hours per week as the people who're counted on to police them.
3. The most skillful regulators often move eventually to work in regulated institutions, weakening the effectiveness of the regulatory process and spilling its secrets.
4. **Hedge funds and derivatives are behind many of the excesses, and it will be particularly hard to get them under control.** Today, one huge area of uncertainty is credit default swaps, particularly with regard to capital adequacy and counterparty risk. It's not a coincidence that CDS are derivatives with heavy hedge fund involvement. How might they be regulated?
5. **Derivatives are particularly hard to regulate because it's difficult to quantify the risk they entail.** Let's take the simplest example: you sell someone a "naked call" that gives him the right to buy from you for \$2 apiece 100 shares of a stock you don't own. If the stock goes to \$5, you lose \$300 (the difference between the \$2 you've been paid and the \$5 you now must pay to buy 100 shares to deliver). If it goes to \$10, you're down \$800. At \$100, you're down \$9,800. At \$1,000, you're down \$99,800. At \$10,000, it's \$999,800, and so on. With naked call writing (and its equivalent, naked short selling), the potential loss is theoretically unlimited. So what's the right amount of risk to show on your balance sheet? No one can say. Should it be the "worst case"? And what is that? Or how about a model-derived estimate of the likely outcome? The last few months certainly showed those to be useless.
6. **It's worth noting that banks, probably the most regulated of our financial institutions, are reporting the biggest losses. Regulation can be improved and tightened, but it's hard to believe that it actually can be counted on to prevent crises.** Similarly, the weaknesses in the mortgage loan generation process were huge, but no regulator spoke out against them.
7. It's been proposed that financial institutions should be required to stress-test their ability to cope in difficult times. But how bad an environment should they be able to survive? What is the worst case, and should banks have to prepare for it? **If banks always were required to be able to survive the conditions of February and March, for instance, they might never make a loan.**

8. **Regulatory proposals are also likely to include calls for more and better risk management.** But the risk management profession's exertions in the last ten years probably exceeded the sum of its efforts prior thereto. Those efforts certainly didn't head off the current crisis. In fact, it's highly likely that risk managers' blessings led to a false sense of security in recent years, and thus to more confident (and greater) risk taking.
9. Since many of the biggest recent errors occurred in the area of credit ratings, **it's appropriate to ask whether regulation could make ratings more accurate.** According to an article in the Herald Tribune of April 25,

Senator Chris Dodd . . . practically begged Christopher Cox, the SEC chairman, to ask for new authority. He suggested that perhaps it would be a good idea to leave credit ratings to some kind of non-profit agency that would not have conflicts of interest. Both he and [Senator] Shelby suggested that the SEC should revoke the operating license of a credit rating agency that was wrong too often.

Can you imagine anything along these lines working? **Would you like to see credit ratings being set by an agency lacking economic motivation?** Who would determine whether they'd been "wrong too often"? And would "wrong too often" include ratings that proved to be too low, or just too high? I've seen a lot of both in the last forty years.

10. Likewise, some of this cycle's greatest gaffes came from having people make loans who lacked an ongoing stake in their creditworthiness. So it's been suggested that lenders should be required to have money at risk in loans even after they've been securitized and sold onward. Could regulators possibly prevent a highly motivated lender from getting around this requirement? How, for instance, would they keep an institution from hedging its bets through offsetting positions in derivatives?
11. A number of the proposals I've read relate to financial executives' compensation. Bankers' bonuses should be related to performance that has been adjusted for the risks entailed. And they should be long-term in nature and subject to being clawed back if profits turn into losses later on. **Can government possibly regulate compensation in the private sector? And should it under our system?** I would say "no" to both.
12. **Finally, the main things that gave rise to the pain this time around were imprudence, insufficient skepticism and excessive faith in innovation.** The International Herald Tribune of March 29 said, "Democrats in Congress . . . are pushing for tougher restrictions on risky lending." And I read elsewhere a suggestion that mortgage lenders should have to act responsibly. How can these things be regulated? **How might a regulator require good judgment, and how would it be measured?**

I think Alan Greenspan did an excellent job of summing up the situation in an op-ed piece in the Financial Times of April 7,

Regulators, to be effective, have to be forward-looking to anticipate the next financial malfunction. This has not proved feasible. Regulators confronting real-

time uncertainty have rarely, if ever, been able to achieve the level of future clarity required to act pre-emptively. Most regulatory activity focuses on activities that precipitated previous crises.

Aside from far greater efforts to ferret out fraud (a long-time concern of mine), would a material tightening of regulation improve financial performance? I doubt it. **The problem is not the lack of regulation but unrealistic expectations about what regulators are able to prevent.** How can we otherwise explain how the UK's Financial Services Authority, whose effectiveness is held in such high regard, fumbled Northern Rock? Or in the US, our best examiners have repeatedly failed over the years. These are not aberrations.

The core of the subprime problem lies with the misjudgments of the investment community. . . . Even with full authority to intervene, it is not credible that regulators would have been able to prevent the subprime debacle. (Emphasis added)

Martin Wolf sized the challenge in the FT of April 16:

If regulation is to be effective, it must cover all relevant institutions and the entire balance sheet, in all significant countries; it must focus on capital, liquidity and transparency; and, not least, it must make finance less pro-cyclical.

That's a tall order. The results are unlikely to stack up well against the goals.

No, government intervention doesn't hold the key to a financial system existence free of extremes and crises . . . any more than *laissez-faire* does. But the trend is likely to be in the direction of regulation. The truth is that cycles, with their dangerous excesses, will cease to occur only when human emotion and the pursuit of profit no longer go to extremes. Neither government intervention nor the free market will ever produce that result.

The Black Swan

The best-known bird around today is *The Black Swan*, the second book from Nassim Nicolas Taleb. You may remember Taleb as the author of *Fooled by Randomness*, which I've described as an essential read (see "Returns and How They Get That Way," October 2002, and "Pigweed," December 2006). He's an ex-hedge fund manager and self-styled philosopher whose books are nearly impenetrable (I suspect intentionally). But they also contain some incredibly important ideas.

The main thrust of *Fooled by Randomness* was that while many of the forces that shape investment performance – or history in general – are random in nature, people often ignore that fact and give them meaning that would be warranted only if they weren't random. Thus the top performing investor in a given year may be the manager – in Taleb's terminology, the "lucky

idiot” – who took an extreme and unwise position and was bailed out by a highly improbable event that occurred by chance. For that reason, one year of outstanding performance says absolutely nothing about the likelihood of another.

The Black Swan continues in that vein, emphasizing the dangers of overestimating knowledge and predictive power. The book gets its name – and its theme – from some unusual Australian birds which, never having been seen before foreigners began to visit, were considered in Europe not to exist.

According to Taleb, there are three criteria for a “black swan.” The first two are that it should be “an outlier” and carry “an extreme impact.” **The fact that these “highly consequential events” are infrequently occurring and improbable often is taken to mean they’re nonexistent and impossible. The difference between the two may be small, but it’s highly significant.**

Taleb’s third criterion is that black swan phenomena have “retrospective (though not prospective) predictability.” **And because people are able to “concoct explanations” for them after the fact, they end up believing themselves capable of understanding the causes and predicting future occurrences.** In short, they underestimate the limits on foreknowledge with regard to these events – a regular theme of mine, as you know – and underrate the role of randomness. To simplify their world and render it subject to established statistical analysis, quants attribute standard properties – like the familiar bell-shaped curve – to events that are far less regular than they should be for this approach to be valid.

The publication of *The Black Swan* last year was extremely well timed, because many of the infamous recent events satisfy Taleb’s criteria.

- The greatest errors in mortgage securitization arose because “home prices have never declined nationally” was taken to mean “home prices can’t decline nationally.”
- Innovative financial products were modeled on the basis of common probability distributions that may have been inapplicable to the phenomena being studied. Thus the possibilities were oversimplified by recent business school graduates who’d never been out bird-watching in the real world.
- In the end, events that had been described as highly unlikely happened. But they shouldn’t have come as complete surprises and should have been anticipated. Models had led people to consider things with a 1% chance of loss as riskless. **Once in a while, however, people need a reminder that “unlikely” isn’t synonymous with “impossible.”** Black swans do occur.

Now, with the final bullet point above in mind, let’s talk about the black swan as a practical matter, not a topic for philosophic rumination. It’s easy to say black swans should be prepared for, and that the people who fell into the last few years’ traps ignored obvious risks. My December memo “No Different This Time” included the following among the key lessons of ‘07:

Investment survival has to be achieved in the short run, not on average over the long run. That’s why we must never forget the six-foot-tall man who

drowned crossing the stream that was five feet deep on average. **Investors have to make it through the low points.**

This statement makes obvious sense. Certainly investors must brace for untoward developments. There are lots of forms of financial activity that reasonably can be expected to work on average, but they might give you one bad day on which you melt down because of a precarious structure or excess leverage.

But is it really that simple? It's easy to say you should prepare for bad days. But how bad? What's the worst case, and must you be equipped to meet it every day?

Like everything else in investing, this isn't a matter of black and white. **The amount of risk you'll bear is a function of the extent to which you choose to pursue return. The amount of safety you build into your portfolio should be based on how much potential return you're willing to forgo.** There's no right answer, just trade-offs. That's why I went on from the above as follows:

Because ensuring the ability to [survive] under adverse circumstances is incompatible with maximizing returns in the good times, investors must choose between the two.

One of the most interesting questions I've pondered over the years is this: **How much should we spend – be it in the form of insurance premiums or forgone returns – to protect against the “improbable disaster” (my term for the black swan)?** But that's all it remains: a question. It's for each of us to answer in our own way.

Birds on a Wire

There's an old riddle about ten birds sitting on a telephone wire. A hunter shoots one. How many are left? The usual response is nine. But the correct answer is none; the rest are frightened by the gunshot and fly away. Maybe it's a joke, but it illustrates the ease with which ramifications – what my British friends call “knock-on effects” – are overlooked.

In “It's All Good . . . Really?” I discussed the way people were describing the events of last summer as an isolated subprime crisis and ignoring the potential for contagion. Now most see that the “subprime crisis” was just the first act in what might be a long period of generalized economic difficulty and market weakness.

The longer I think about economic and investment trends, the more I view every development as a reaction to something else. And you've probably noticed my inability to talk about current events without discussing their precursors. I see the events since last summer – and those that will stretch into the coming months and perhaps years – as a chain reaction:

- The **subprime crisis** resulted from trends that had been building during the preceding years: leverage, securitization and tranching, financial engineering, looser ratings, unregulated non-

- The **credit crunch** was an obvious next step. A number of more generalized developments resulted from the mess in residential mortgages:
 - rising risk aversion,
 - higher demanded risk premiums, and thus lower prices for risky assets,
 - the withdrawal of leverage and liquidity,
 - leveraged fund meltdowns and frightening headlines,
 - losses at banks and thus endangerment of their capital adequacy, and
 - hoarding of capital and the unavailability of new loans.

- This resulted in **problems at financial institutions**. Losses on highly leveraged investments were sure to lead to a crisis mentality, which could morph easily into a plain old crisis. What are the characteristics of financial institutions?
 - **high leverage**,
 - **near-total reliance on short-term deposits and borrowings** to fund illiquid, longer-term assets,
 - **risk bearing** – that’s what their business consists of, and it’s by doing so that they earn lending spreads (if they borrowed safe and lent safe, where would the spread come from?), and
 - **extremely low transparency**.

What greater recipe could there be for a drying up of confidence? If a financial institution loses the confidence of its customers, what’s to prevent a run on the bank? Nothing, as the UK found out in September with Northern Rock and the US found out in March with Bear Stearns. And what can inject fear into an economy more than doubt about the safety of its financial institutions?

- The main shoe left to drop concerns **the impact on the broader economy**. Economies run on confidence. People spend on non-necessities because they expect the future to be good and their incomes to grow. Businesses expand plant, workforce and inventory because they expect sales to increase. Financial institutions lend because they expect to be repaid with interest. Investors provide capital because they expect the value of assets to increase. When doubt is shed on these expectations, the growth process stalls. When the economy contracts for two consecutive quarters, a recession is declared, and positive assumptions become further in doubt.

Already, businesses are reporting declining or disappointing earnings (even General Electric). Unemployment is on the rise. Higher prices for oil and food are likely to cut into consumers’ ability to spend. And their psyches have been damaged by scary headlines they may or may not

understand. Consumer confidence is at low levels, and fewer Americans expect an improving future. Much of the growth in consumer spending has been abetted by the more widespread availability of credit. Now, less credit should mean less spending. These aren't the conditions for a vibrant economy.

There's a strong consensus that we'll see a recession – and a possibility we're in one already. GDP grew in the first quarter, but final sales were down and output increased only because businesses added to inventories. These additions likely were involuntary, and when stopped or reversed, GDP growth certainly could go negative.

Please note that a depressed economy isn't the end of the line. Slower consumer and industrial activity could feed back to the beginning of the process, causing further house price depreciation, further write-downs, a further credit contraction and so forth. And then, when levels get low enough, something mysteriously will cause the cycle to turn positive.

Things don't happen in isolation in economies and markets. Birds do flock together. The implications of past events will spread further.

Phoenix from the Ashes?

As always, there's a tug-of-war going on between the optimists and the pessimists. This time, however, the stakes are unusually high and the rhetoric proportional to the potentially momentous consequences.

Over the last few weeks, the markets rose based on statements to the effect that the worst had passed: "We're closer to the end than the beginning" (Lloyd Blankfein of Goldman Sachs). "Maybe 75 to 80 percent over. . ." (Jamie Dimon of JPMorgan Chase). The worst is "behind us" (Richard Fuld of Lehman Brothers). The subprime market in the U.S. has reached its eighth inning or maybe the "top of the ninth" (Morgan Stanley's John Mack).

On the other hand, John Thain of Merrill Lynch said, "I hope those who say we are at the end are correct. I am somewhat more skeptical." Dan Fuss of Loomis Sayles, a highly experienced bond manager with an excellent track record, said, "This is the most worrisome financial situation I've seen in my working lifetime" [which approximates fifty years]. And George Soros described this go-round as "much more serious than any other financial crisis since the end of World War II."

People are talking about March 17, the day JPMorgan Chase rescued Bear Stearns, as the bottom. Psychology was terrible in the weeks leading up to that event; things would have melted down much further in the absence of a rescue; and psychology and markets picked up substantially thereafter. **Certainly that day was "a bottom," but I'm not so sure it was "the bottom."**

The Bear Stearns rescue dealt with the credit crunch, investor attitudes and the possibility of a downward spiral among financial institutions. But it didn't mark the end of mortgage

defaults or economic weakness. Mortgages will continue to go unpaid, and the numbers may accelerate if interest rates take adjustable-rate loan payments higher and if house prices continue to fall. Further, nothing that was done in March will preclude economic slowdown, falling corporate profits or defaults on debt. Finally, it doesn't seem to have done much for the availability of credit. Several elements are likely to remain – or become – further depressants:

- **Bank write-downs will continue to be reported.** The majority of the banks' subprime-related losses may have surfaced **as relate to the current level of house price depreciation and mortgage default.** That doesn't mean these trends won't go further, and thus that the reservoir of unreported losses won't be refilled. The IMF has projected total mortgage-related losses of \$1 trillion. Certainly the write-downs announced to date haven't approached that figure. And there's a broad consensus that most holders haven't been as forthcoming on this subject as the U.S. banks.

Progress is being made toward breaking the logjam, but we're not done yet, and there continue to be additions to the backlog. As banks report large write-downs, I can't help but sense that the immediate reaction is, "I wonder how much more remains." Only when people stop thinking that way will real progress have been made toward easing the credit crunch.

- Similarly, sales of "hung" bridge loans are increasing, and clearly some investment banks are willing to take their medicine with regard to the extent to which loans bought in 2006 and 2007 are unsalable at par. Recently we have seen sales at 90, often with financing provided by the sellers. **But just as in the case of mortgage losses, it's quite possible that new obligations to lend will re-burden the financial institutions' balance sheets,** as companies draw against the excess credit lines that were arranged at the time they changed hands in buyouts.
- **The availability of credit is still a question mark,** although things seem to be getting better. Despite the Fed's low rates and all central banks' massive injections of liquidity, inter-bank interest rates still incorporate significant yield spreads and volumes are limited. On April 28, the Financial Times quoted John Maynard Keynes:

Whilst the weakening of credit is sufficient to bring about a collapse, its strengthening, though a necessary condition of recovery, is not a sufficient condition.

In other words, the FT said, "just because the banks are not going bust does not mean that they can lend as before – nor would they if they could."

- Commercial real estate prices, like home prices, are coming off irrational highs achieved because of the oversupply of investment capital in the last few years. **The coincidence of a broad real estate collapse with a significant recession has the potential to make this a painful episode.** But few prominent commercial defaults and failed refinancings have been reported to date.

- **The economic news, while not dire at the moment, isn't rosy.** Consumer spending, inflation, employment and business investment all remain exposed to negative future developments. Default rates among highly levered companies have just begun to rise.
- **Finally, the viability of derivatives such as credit default swaps has yet to be tested.** That means either (a) they're not going to cause trouble, or (b) they're going to cause trouble and have yet to do so. This is another case where potential negatives have yet to be dispelled.

The markets have seen substantial gains since the time of Bear Stearns's rescue. They give me the impression that people who refrained from trying to "catch a falling knife" may have concluded that they waited too long, and thus they rushed to buy out of fear that they'd look bad if they stayed uninvested. The FT of April 28 summed up in a way I thought was very much on target:

The awkward truth is that nobody knows for sure how severe an impact the credit crunch will prove to have on the global economy and on financial markets.

On fundamental grounds a wealth-preserving investor might well feel justified in being cautious until the extent of the downside becomes clearer. **The beauty contest approach** [in which, rather than bet on who's the prettiest contestant, people bet on who most people will judge to be the prettiest contestant], **however, suggests that many professional investors are taking the view that however bad their private fears, the majority of their counterparts are looking through the immediate fallout to a rosier future.**

Just as markets anticipate eight of the next five recessions, so too they can look forward to eight of the next five bull market recoveries. (Emphasis added)

I'm not saying the pessimists are right and the optimists are wrong, or that we truly face an ongoing crisis. Rather, I think the possibility is there and several more shoes remain capable of dropping. Importantly, while mortgage securities and leveraged loans have gone through the wringer and arguably might be cheap, most other assets are as yet unscathed or have rebounded. Stocks, in particular, do not seem to reflect the possibility that this economy's goose is cooked, having declined only slightly from 2007's all-time highs.

* * *

So you want to know, "Is it over?" Here's my bottom line:

- **There's been a significant correction of the excesses of a year ago.** Prices are down and risk premiums are up. Fear and risk aversion have been brought back into the equation; unbridled optimism is no longer the norm.

- **A good part of the losses have been recognized that relate to the fundamental deterioration – and especially the mortgage defaults – to date.**
- **Psychology, which reached “end-of-the-world” levels in the days leading up to the rescue of Bear Stearns, is back from the brink and on the upswing.** Although this could be a worrisome sign of inadequate caution, the risk that psychology will spur a massive downward spiral seems to be off the table for now.
- **However, the foreseeable future is not without significant risks, many of which are real, not psychological** (to the extent the two can be distinguished in economics). There could easily be further house price depreciation, causing more mortgage defaults and requiring additional write-downs. American consumers, buffeted by rising prices for energy and food and concerned about the future, could easily slow their spending and further weaken the economy. And we continue to believe that many high-priced, highly leveraged private equity deals will fail to survive an economic slowdown.

The outlook continues to call for prudence . . . although not as much or as urgently as a year or two ago. Then, people were investing at low returns in the belief that nothing could go wrong. Today, that optimism has been dispelled and prospective returns embody more generous risk premiums.

However, only when a great deal of caution has been built into the markets – and hopefully an excess of caution – is it time to turn highly aggressive. We’re not there yet, but there’s reason to believe we’re moving in that direction.

May 16, 2008

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Memo to: Oaktree Clients
From: Howard Marks
Re: Doesn't Make Sense

Academics have their theories about market efficiency. Because market participants are well-informed and rational, they say, markets make correct decisions and smoothly assign the right price to each asset. It's for this reason that investors can't routinely find the mispricings they need in order to be able to beat the market.

But investors – and most of the people living on this planet, for that matter – are far from the unemotional computing machines the academics assume them to be. They make faulty decisions, fall for scams and swing from one irrational position to another all the time. **In fact, I marvel at how many things take place in the worlds of business, investments and politics that stem from irrationality and just don't make sense.** It's my purpose here to write about a few.

Letting the Market Call the Tune

In “Whodunit,” I talked about Chuck Prince, the ex-CEO of Citigroup. Early in July of 2007, he astutely observed, “When the music stops, in terms of liquidity, things will get complicated.” However, he went on to add, **“as long as the music is playing, you've got to get up and dance. We're still dancing.”** Because Citigroup danced as much as the other banks or more – and lost as much or more on subprime-related write-downs – Prince lost his job in November 2007.

The portion of Prince's statement that I've highlighted seems emblematic of the attitudes that prevailed from early 2003 until the summer of 2007. People were doing risky things – often even though they recognized the attendant risk, as Prince seemed to do – because they saw no alternative if they wanted to remain competitive.

Upon hearing of Prince's departure, my immediate reaction was to think (a) when a firm fares so badly, the CEO may deserve to lose his job, and (b) to avoid that fate, Prince just had to cause Citi to avoid the risky behavior he identified. If he had done the latter, Citi would be among the big winners today instead of the losers; it wouldn't have to recapitalize by selling equity at depressed prices; and instead it would have funds with which to take advantage of today's better market environment. So in saying that if the music was playing, Citi had to dance – and thus letting the market call the tune – Prince's leadership was flawed.

Compulsory Short-Termism

But is it right to say Prince and Citi could have avoided trouble by refusing to go along? Let's do what some DVDs let you do nowadays: go back and consider an alternative ending. It's July 2005 instead of July 2007. Presciently, Chuck Prince says, "When the music stops, in terms of liquidity, things will get complicated. We're not going to get caught in that trap. As of today, we're adopting a conservative stance toward loans, mortgages, subprime, CDOs and SIVs. The others can dance all they want; we're sitting this one out."

What would've happened? Rather than lose his job in late 2007, he probably would have lost it sooner. Why? Because from whenever he made that statement until July 2007, Prince would have looked dumb. While other banks were gaining market share, Citi's share would have been shrinking. And while other banks were borrowing on the cheap to make mortgage-related investments at seemingly attractive spreads, Citi would have been on the sidelines, forgoing easy profits. Shareholders would have been yelling for Prince's scalp.

The bottom line is one of my three favorite adages: **Being too far ahead of your time is indistinguishable from being wrong.**

Of the two things I think are most wrong about American business, the worst is short-termism. (The other is the ability of executives to thrive while their companies do poorly.) **Companies are rewarded for short-term success and penalized for short-term failure, whereas few people ask about the long term.** The only thing that matters is "What have you done for me lately?" A lot of this emanates from stockholders.

In a memo several years ago, I listed a few phrases that have sunk into obscurity over the course of my career. They included "fiduciary duty," "preservation of capital" and "dividend yield." Another is "long-term investor."

Most investment managers are measured against a benchmark every quarter and expected to add value. Some clients have their fingers on the trigger, ready to axe a manager who underperforms for a year or two. For this reason, managers sit with their own fingers on the trigger, ready to dump a stock or bond whose short-term performance lags. And company CEOs whose securities are laggards are likewise on the hot-seat, with boards that rarely support executives who disappoint Wall Street.

Too many people think of the long run as nothing but a series of short runs. The way to have the best five-year investment record, they think, is by sequentially assembling the twenty portfolios that will produce the best performance in each of the next twenty quarters. No one wants to invest in a company that may lag until long-term investments pay off down the road. They'll just sell its stock today, assuming they'll be able to buy it back later.

Understanding this, companies face great pressure to emphasize short-term results. What might they do in response?

- Maximize revenues (perhaps by stuffing pipelines and offering discounts that accelerate future sales into the present).
- Minimize expenses in slow-to-bloom areas like research and development.
- Borrow to buy back stock, because debt capital is cheap and equity is expensive (despite the fact that equity provides safety and leverage amplifies risk).

Do you want your companies doing these things? Probably not. But do the collective external pressures force companies in these directions? Absolutely. **The things that maximize profits in the short run often serve to decrease profits and increase risk in the long run, but they can be mandatory these days.**

Investors are increasingly short-sighted, and none more so than some hedge funds, with their emphasis on year-by-year incentive fees. The average stock might deliver a return roughly in line with the growth in corporate profits, and the stocks of better companies should outperform in the long run, but hedge funds (and their investors) expect more. They're strongly motivated to hold a subset of stocks that will be the best near-term performers. One approach is to take positions and then pressure companies to "maximize shareholder value." With their focus on short-run performance and short-run compensation, many of the things they advocate – like spin-offs, stock buy-backs and oversized dividends – can be less than optimal for the long run. But that's not their concern.

This kind of behavior exemplifies the debate over *laissez-faire* described in "The Aviary" in May. **In the long run, it should be good for society to have capital in the hands of sophisticated, focused, bright managers who are free of guidelines and can go anywhere in pursuit of profit. In theory, it should be a positive that they're willing to bet against the herd, adopt unpopular positions and take on unresponsive managements. But in the short run, they can have a destabilizing effect, especially when several act in common.** Maybe it just proves that free-market solutions – like just about everything else – have both positive and negative aspects.

If Chuck Prince had taken Citigroup to the sidelines in 2005, it's highly likely that some hedge funds would have tried to force him out. And with Citi looking unduly conservative, the board might not have been in a position to resist. **So being right isn't always enough when you run a public company. You have to be right in the short run. And in choosing a course of action, the one that's right for the short run generally will be preferred over the one that's right for the long run. None of this seems ideal.**

Unreliable Ratings

Probably the group that had the most power and yet covered itself with the least distinction over the last few years – and has been outed to the greatest extent – are the credit rating agencies. The rating agencies were accorded quasi-official status as the policemen of the credit markets, and they failed miserably.

This is nothing new. I've always considered the rating agencies to be error-prone, and much of my career has consisted of taking advantage of their mistakes. They've often rated seemingly safe bonds too high and risky bonds too low. They've been slow to adjust ratings, but when finally they did change, they usually overshot. **The bottom line is that managing a bond portfolio according to ratings would be somewhere between unavailing and disastrous. Profits are more likely to be found in gaming against the ratings.**

Nevertheless, when the government felt Wall Street had to be policed and debt investors protected, they turned to the agencies. Before doing so, I doubt anyone checked to see how accurate ratings have been. Now we know. Thousands of ratings of structured mortgage securities turned out to be too high and were adjusted downward, often many notches at a time. The CDO tranche that didn't have to be downgraded is the exception, not the rule. In other words, the ratings were grossly wrong.

In my view, a triple-A rating shouldn't just imply a low probability of default, but a low probability of downgrading as well. The agencies may say they were blindsided by developments in residential defaults, but I think a triple-A rating should also imply a low probability of being blindsided. To follow on with the "black swan" thought process, something potentially subject to an "improbable disaster" shouldn't receive a triple-A rating. But clearly a lot did.

A Model Destined to Fail

The bottom line's simple: you can't get dependable results from a faulty process. Most people realize now that the rating process was highly flawed.

I've written before about the biggest weakness: the fact that rating agencies are hired and paid by the issuers whose debt they're rating. In "Now It's All Bad?" (September 2007), I compared this to a trial where the defendant picks and pays the judge. But I realize now that I overlooked an important element in the equation. **It's actually a trial where the defendant gets to ask a number of prospective judges what verdict they'd reach before choosing one.** Issuers can describe a proposed issue to multiple agencies, hear back as to what rating they're likely to assign, and then hire the one they want.

Think about an agency's incentives under this arrangement: the fee goes to the one willing to supply the highest rating. Go along and your profits grow; stand on principle and you're left behind.

When I came into this business in the 1960s, Moody's and Standard & Poor's made their money selling subscriptions to their publications. Thus their customers were investors, and they weren't beholden to the issuers. But when they began to derive most of their revenue from the issuers, the agencies understood who was buttering their bread.

There's a further problem: only above-average judgment can make you a superior investor. The consensus view of the future is incorporated in market prices. Only someone more astute than the consensus can help you do better than average.

Now let's turn to the rating process. **Anyone can compute current financial ratios and see how a company's doing today. And the future looks the same to the average person as it does to the consensus. Thus, for a helpful assessment of a company's prospects, you need someone who can foresee possibilities and risks better than most.** But if someone possesses above-average insight into bonds' prospects, will he assign credit ratings for a living, or will he get a job managing investments? Money isn't everything, but most people tend toward their highest and best use. **I think it's fair to say the rating agencies don't attract bond gurus.**

Since the ratings business is highly competitive and profit margins are slim, agency analysts tend to be paid for high ratings and "responsiveness," as opposed to unique insight. Principled, conservative decisions aren't rewarded, as is now plain to see.

Moody's disclosed in May that, because of a programming error, eleven European CPDOs (complex investment vehicles formed to write large amounts of credit insurance) had been incorrectly rated triple-A instead of double-A. Okay, everyone makes mistakes. But the plot thickens.

According to *The New York Times* of July 2, the law firm of Sullivan & Cromwell conducted an investigation for Moody's and found that the ratings hadn't been corrected even after the error came to light. Its report,

. . . blamed employees in charge of monitoring and adjusting ratings for considering "factors inappropriate to the rating process" after the errors were discovered. . . . In a statement, Moody's said unidentified employees had violated a code that required analysts to consider only credit factors, not "the potential impact on Moody's, or an issuer, an investor or other market participant."

It's not exactly clear what happened, and I don't think anyone's trying to make it particularly clear. It seems, however, that Moody's employees overlooked the ratings errors that came to light for "business reasons."

According to an article on ratings in *The Wall Street Journal* of May 23, Moody's and Fitch,

. . . acknowledged they have switched analysts assigned to rate bonds after receiving requests to do so from bond issuers or their bankers. Changes usually were made after a specific bond was rated, meaning the analyst wouldn't work on the bond issuer's next deal, according to current and former officials at the credit-rating firms. . . .

At Moody's, at least one analyst in the group that rated collateralized debt obligations, or CDOs, was moved off a particular investment bank's deals within the past few years after bankers requested an analyst who raised fewer questions, according to people familiar with the matter.

Another mortgage analyst at Moody's was moved to the firm's surveillance unit after a Moody's official agreed with an investment banker's opinion that the analyst was too fussy, a person familiar with the situation said. . . .

"We're a service business," says John Bonfiglio, group managing director of structured finance at Fitch. [Emphasis added]

Lastly, on July 9, *The New York Times* provided these tidbits from internal rating agency emails, which were part of an SEC report on its investigation of the agencies:

"We do not have the resources to support what we are doing now."

"I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision and if so, how much?"

"We are meeting with your group this week to discuss adjusting criteria for rating C.D.O.'s of real estate assets this week because of the ongoing threat of losing deals."

It doesn't make sense for unregulated and sometimes unprofessional organizations, operating under the wrong incentives and performing tasks that are above their heads, to be appointed watchdogs of the capital markets. But that's what happened.

When It's Good to Be Bad

Only in an Alice-in-Wonderland world can there be benefits in having a weak credit rating. But today's complex, rules-based accounting system makes it possible.

On May 18, *The Wall Street Journal* published the story of Radian Group, a bond and mortgage insurer. Although its business was poor, an accounting gain enabled it to report a \$195 million net profit for the first quarter, as opposed to the \$215 million loss it would have reported otherwise. However, this was an unusual gain. It didn't arise because the value of Radian's assets went up, but rather because the value of its liabilities went down.

Here's how, according to the *Journal*:

One of the basic rules of accounting says that a reduction in the value of a liability leads to a gain that usually boosts profit. Under the new [mark-to-market accounting] rule, companies have to take into account the market's view of their own financial health when considering the market value of some liabilities. In this case, a company's poor health can lead to a reduction in the liability's value. . . .

In other words, if you owe money and the probability you'll pay your debts declines, your financials strengthen. But shouldn't a declining ability to pay be associated with weakness, not strength? **Before enacting rules like this one, someone should ask if they make sense. It doesn't seem anyone did.**

Similarly, mark-to-market accounting can – in the extreme – require a company to value its assets at the prices that would be realized if they all had to be sold today. And those prices are likely to decline as more assets are assumed to need dumping. Liquidation values are far different from intrinsic values or going-concern values. Do we really want to value assets on the assumption that they're all going to be sold immediately? What purpose does that serve?

Blame the Speculators

The current debate over the role of speculators in oil pricing reminds me of Rep. Noah Sweat's classic answer when asked in 1952 what he thought about whiskey:

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 pits 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 be compromised on matters of principle.

I guess you could say Rep. Sweat found the merits of whiskey to be in the eye of the beholder. So, it seems, is the role of “speculators” in the escalation of oil prices.

Politicians don’t seem eager to tell constituents the truth about oil:

- We use too much of it (perhaps because it’s cheaper in the U.S. than elsewhere).
- Our cars are less efficient than they should be.
- A good bit of this year’s increase in the dollar price of oil may be attributable to the fact that a dollar now buys considerably less goods (or other currencies) than it did in December.
- Oh yeah: and Washington completely dropped the ball in areas like fuel efficiency standards.

So it shouldn’t come as a surprise that some politicians are blaming the price rise on other people: speculators. But what is a speculator? That’ll bring an answer like Rep. Sweat’s. Ask a lay person, and the answer will be a shiftless gambler who takes unwise chances in pursuit of unjustified profits.

In the commodities market, a distinction is made between “commercial” and “non-commercial” traders. A commercial trader may buy oil, for example, in the course of its main business (like an airline, utility or oil refiner) and thus have a reason to hedge against price rises. Or it may be an oil producer that wants to protect against falling prices by selling its future production at the current price. People making value judgments deem these to be “legitimate” reasons.

Speculators, on the other hand, are non-commercial traders – anyone without direct reliance on oil in its business. The current furor implies they don’t have valid reasons for buying oil.

But what about the long-term investor who wants to own natural resources as part of a balanced portfolio? Or the individual seeking protection against inflation? Or the sovereign nation that wants to put part of its reserves into something other than depreciation-prone dollars? These motives aren’t “illegitimate,” and they don’t deserve to be disparaged.

In particular, some have suggested that pension funds should be barred from trading in oil. This has to have more to do with scapegoating and short-term perception than it does with preventing improper behavior or solving our nation’s energy problem.

Prices – for everything – are set by the interaction of supply and demand, and short-term swings in these things can swamp long-term fundamentals. Certainly, incremental demand from the kinds of buyers described above may have lifted the recent price of oil above what it otherwise would have been. But upward pressure doubtless came as well from (1) increased consumption (especially in developing countries like China and India), (2) rising international tensions, and (3) the simple fact that, **because a dollar now buys less than it used to, it's logical for sellers to demand more of them per barrel**. How much of the blame rightly falls on the speculators?

Thirty billion barrels of oil are consumed each year worldwide, worth over \$4 trillion at today's prices. Can the buying of oil by investors – even speculators – really be responsible for much of this year's \$1 trillion increase in the total cost of those thirty billion barrels? I don't think that explanation makes much sense.

When major problems arise in the economy or markets, politicians and the media often find it attractive to point fingers at alleged evil doers. That's a lot easier than admitting that regulation fell short, or that we face intractable problems. We're sure to see criticism and even prosecutions following the current economic episode. But any misdeeds are likely to be symptomatic of a lax environment, not causes of the problem, and punishing them is unlikely to be an effective part of the solution.

Eliminating the Fear of Loss

A couple of weeks ago, I had a great talk with Tom Petrino, an insightful business reporter for the *Los Angeles Times*. Calling on our shared experience as Californians, he presented what I consider a very apt analogy. It went like this:

We've all heard about the connection between the Fed's actions and moral hazard. There've been many incidents and scares over the last couple of decades: Black Monday, the meltdown of Long-Term Capital Management, Y2K, the bursting of the tech bubble, 9/11, and a recession here and there. Each time, the Fed rushed in with interest rate cuts and increases in liquidity designed to prevent or offset their depressing effects. A few times, it was said, these actions averted a collapse of the world financial system.

But the cost was moral hazard: a growing expectation that the Fed would bail out imprudent risk takers. By behaving in ways that cause people to think they'll always come to the rescue, authorities encourage risky behavior. And we all share the cost of rescuing the risk takers, whether we participated or not. In this way, the risk taking encouraged by the Fed's policy of protecting participants caused the risks to grow ever-higher. The result is a housing bubble and full-scale credit crunch that together have cost millions of people money and perhaps their homes, pushed financial institutions to the brink, and caused the government to expend a lot of its problem-solving resources.

Tom asked if I didn't see a parallel between the management of our financial system and the policy toward forest fires. The western states experience forest fires all the time, for

any number or reasons: lightning, stray cigarettes, campfires that get out of control, even arson. While undesirable, these frequent fires have a good side: they get rid of the relatively small amount of dry brush created each year during our dry season.

But in recent years, the authorities promptly extinguished these fires to make sure they wouldn't get out of control. As a result, brush was permitted to accumulate from year to year. And this May, when a series of freak lightning storms started 2,000 fires, the built-up brush turned some of them into major conflagrations at a time when fire-fighting resources were stretched thin.

This past Sunday, the 27th, the *Los Angeles Times* kicked off a major series on forest fires. Here's part of what it said:

The government's long campaign to tame wildfires has, perversely, made the problem worse. . . . By stamping out most wildland blazes as quickly as possible, the Forest Service has stymied nature's housekeeping – the frequent, well-behaved fires that once cleaned up the pine forests of the Sierra Nevada and the Southwest. Now, woodlands are tangled with thick growth and dead branches. When fires break out, they often explode.

Sound familiar? Clearly, the analogy between financial crises and forest fires is solid. And I told Tom that just as the Fed's growing tendency to solve every problem led people to take greater risks, the policy of fighting fires early also created moral hazard by encouraging people to build homes further into the forest. It fell to the community to keep those unwisely built structures safe, just as the government now feels it has to rescue subprime borrowers and financial institutions.

Capitalism can produce great results, but participants have to be allowed to both win and lose. If they aren't, they come to believe the only possible outcomes are winning or, at worst, breaking even. **Good business decisions can be made only if the hope for gain is balanced by the fear of loss. The latter must not be eliminated. The system must be allowed to work. Of course, this has to be balanced against the desire to prevent catastrophes, necessitating some very difficult choices.**

Counting on a "V"

Finally, I want to provide a word of caution regarding expectations for recovery. I hear predictions that things will come back next year. Earlier this month, for instance, an elevator news display cited a forecast that home prices will rise 4% in 2009, almost offsetting 2008's decline.

People have become conditioned to expect V-shaped declines and recoveries. We saw quick downs and ups in the markets or the economy in 1987, 1990, 1994, 1998 and 2002. But it doesn't have to be that way. Those of us who were in this business in the 1970s know different.

The '70s saw a 37% decline in the S&P 500 in 1973-74; huge losses in the “nifty-fifty” growth stocks; the Arab oil embargo in 1973; inflation in the high teens; short-term interest rates in the 20s; and an infamous *Business Week* cover story, “The Death of Equities.” Stagflation ruled, and there seemed to be no way out of the wage-price spiral. People wore buttons promoting President Ford’s WIN program (“Whip Inflation Now”), but neither the buttons nor the program did any good. New York stockbrokers were driving cabs, and it was extremely difficult to find employment in the investment industry. That means that in order to be part of the investment industry in the '70s, you pretty much had to have your job by 1969. And that in turn means you had to be at least 21 by 1969 . . . and sixty or older today. There aren’t many of us still working.

I can tell you, no one was talking about a “V” in the 1970s. We experienced financial malaise lasting almost a decade. The best we felt we could hope for was a “saucer-shaped” recovery, a far different story.

As I said in “The Tide Goes Out” in March, economies aren’t hard-wired, and no one knows in advance how things will go. Further, some of the ingredients this time never have been seen before. When taken together, I see problems that may not go away any time soon and the possibility of a sluggish period lasting more than months or quarters.

First, let’s consider financial institutions and the housing market. In recent years, as everyone knows, the former combined with the latter to create a bubble based on the combination of leverage, innovative structuring and heedless buying. Institutions and housing have been gravely hurt, and they’re likely to bring harm to additional sectors of the economy. For their downward spiral to be arrested, I see four things that have to happen:

- Home prices have to stop going down.
- Home mortgages have to be made available.
- Financial institutions have to stop experiencing incremental write-offs.
- Financial institutions have to be able to raise additional capital with which to rebuild their balance sheets.

The problem I see is that each of these four things is dependent on the occurrence of another – a classic chicken-or-the-egg problem. Write-offs won’t stop until home prices stop going down. Prices won’t stop going down until mortgages become available. Mortgages won’t become available until lenders can raise capital. And capital won’t be freely available until write-offs stop coming. Which will happen first, facilitating the others? What will cause it to happen? When?

These things will happen, of course. Maybe for reasons we can’t foresee. Maybe for no apparent reason. And maybe just because things got so bad they couldn’t get any worse. I go through this only to show why I don’t see an easy or quick solution. But then I’m rarely an unbridled optimist.

Second, consumer spending is a principal lynchpin of the economy, and there's no reason to think the near-term outlook here is positive:

- Employment, earnings, the wealth effect and consumer psychology in general are all likely to be negative, and thus to act as depressants on the economy.
- Higher energy costs and higher mortgage payments (driven up as inflation worries lift interest rates) both have the potential to hamper consumer spending.
- Consumers aren't likely to be able to borrow as easily as in the past. Credit cards may not be available as freely. Borrowing on home equity could be nearly impossible and, anyway, there isn't as much equity to borrow against.
- The American consumer hasn't saved in years and thus has very little in the bank to spend.
- The consumer may realize that savings are essential – at last. If so, in order to save, he'll have to spend less than he makes – at last. This, too, will depress spending.

The record over the last decade – and even the first half of 2008 – shows the American consumer to be incredibly resilient and unwilling to break the spending habit. **Thus it isn't impossible that spending will stay strong . . . just illogical.**

Basically, I think this economy has to hunker down. Financial institutions have to strengthen their balance sheets. Consumers should do so as well. There should be less risk tolerance and financial innovation. Regulation is destined to increase, and in exchange for its support of financial institutions, the Federal government is likely to demand that they carry less leverage and take less risk. Thus financing could be scarce.

But positives do exist. Dollar-denominated exports look very cheap to the rest of the world and will bolster the U.S. economy. And the Fed will do everything possible to help (but it can reduce rates only so far and has to remain vigilant regarding inflation).

The usual tug-of-war is taking place between the optimists and the pessimists. On July 18, the *Financial Times* quoted Deutsche Bank chief executive, Josef Ackermann, as saying, "We are seeing the beginning of the end of the crisis." But the very next day, *The New York Times* quoted Alan Blinder (ex-vice chairman of the Fed board of governors): "The financial system looks substantially worse now than it did a month ago."

On balance, I continue to think the odds favor economic sluggishness for a not-insubstantial period of time. **Given today's general dearth of beaten-down assets outside of residential real estate and financial institutions, investing gradually probably won't cause you to miss great opportunities. But it will keep you out of trouble and ensure that you have capital with which to take advantage of any bargains ahead. In my book, going slow here makes the most sense.**

July 31, 2008

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Memo to: Oaktree Clients
From: Howard Marks
Re: What Worries Me

Especially in times like these, people often ask what keeps me up at night. Well I'll tell you a few things it's not: that Oaktree will suddenly depart from its investment philosophy; that some of our accounts will trail their benchmark for a year; or that the markets will be so weak that we can't earn returns (or so strong that there aren't any bargains). And it's certainly not that I'll meet up with that bus I hear so much about.

My real worries concern the big picture and the long term. Most of them have to do with America's future and the world in which my children and grandchildren will live. In this regard, I think there's a lot to worry about. I'm not going to spend this memo discussing things as mundane as investment cycles, or as cosmic as environmental deterioration, global warming or terrorism. There's enough to talk about in terms of largely economic issues without going into areas like those. And having covered them below, I promise to go back to my day job thinking about investments.

I hope this memo will be well received. I fear some may think it's un-American or unpatriotic, but I assure you I'm neither. It'll certainly seem negative and dreary; I admit up front that I see the problems more clearly than the solutions. But I hope this memo will raise some questions in readers' minds and contribute to constructive debate.

Further, I hope it'll be of interest to Oaktree's clients outside the U.S. While you may not be exposed to these issues to the degree we are at home, (a) you may want to know what I think the U.S. is up against, and (b) at bottom, we're all in this together – all nations are intertwined. And who knows: you might be looking for farsighted help with your countries' long-term problems, just like I am.

The American Century

The truth is that it's great to live in America. Ours isn't the only wonderful country, or the only good place to live, but we've benefited from:

- 230 years of stable democratic government;
- 140 years without civil war;
- the generally peaceful co-existence of a highly heterogeneous population;
- very high levels of personal freedom and opportunity;
- a highly functioning free-market economy;
- great educational institutions;
- vast land mass and natural resources; and
- a highly productive, inventive and entrepreneurial citizenry.

No one alive today has experienced anything other than American preeminence. In fact, the twentieth century has been called “The American Century.” But there’s no reason why the twenty-first century necessarily will be another.

National preeminence – like most other things – is cyclical, not permanent. Given time, leading nations overextend themselves, lose their energy or squander their advantages. They get fat and happy, and they relax. Underdogs try harder and rise from a lower base. Perhaps they study the leaders and learn how to emulate them. And perhaps they begin to make better use of untapped resources and underutilized labor forces. They may even benefit as the leaders share the wealth (such as the U.S. did through the Marshall Plan after World War II). Regardless of the reasons, just as the U.S. supplanted colonial powers like England, France, Spain and Portugal that had held sway earlier, countries like China, India, Russia and Brazil now seem likely to grow faster than the U.S. in the twenty-first century, narrow the gap and enjoy their time in the sun.

In Praise of the Melting Pot

One of the greatest sources of America’s growth and preeminence has been the bounty of immigration. With the exception of the Native American Indians, there was no one here 500 years ago. We’re a country of immigrants. We’ve benefited as waves of foreigners moved to the U.S. to escape mistreatment or seek opportunity. I never forget that my grandparents weren’t born here, and how far I’ve been able to progress nonetheless.

When I was a kid in the 1950s, a joke asked why we were ahead of the Russians in technology. The answer: our German scientists were better than theirs. **This country attracted people from all over the world, gave them unprecedented opportunity, and permitted the most talented to rise to the top. What a great recipe for success.**

But today the outlook isn’t the same:

- The stick isn’t as strong as it used to be: economies and living conditions in other countries have gotten better and continue to do so.
- The carrot isn’t as strong, either: we’re no longer the only country offering opportunity.
- The barriers to entry threaten to rise, as some Americans consider immigration one of our biggest problems. And 9/11 has made visas, including those for students, much harder to obtain.

My involvement as a university trustee has exposed me to a developing trend. It used to be that foreign students were eager to come to the U.S. to gain a higher education and then stay to pursue their fortunes. They still want to come for the education, but today many want to return to participate in economic booms in their native countries. This makes me wonder whether there’ll come a day when the opportunity for a first-class U.S. education isn’t as much of a draw, because other countries will have developed

comparable educational institutions of their own. That day seems far off – institutions like these don't arise in an instant – but it isn't an impossibility.

Many newcomers to the U.S. have found success in engineering, where their technical skills could be put to good use and language skills may have been less critical. Now, however, we hear from Silicon Valley that engineers are harder to attract and retain because of the trends described above. I'm told that in certain fields (like aerospace), U.S. engineers are declining in number and their average age is rising.

America's preeminence depends in part on continuing to attract the world's best and brightest, but the outlook for doing so is not all it was in the past.

Standard of Living

In many ways, including materially, Americans have enjoyed a wonderful standard of living over the last hundred years. Considering creature comforts such as housing, food, sanitation, healthcare, leisure and luxuries, ours may have been the highest standard of living in the world. That raises three questions:

1. Why should we continue to enjoy the highest standard of living?
2. Why should it continue to improve?
3. And why should the rate of improvement outpace that of the rest of the world?

We often see poll results showing that increasing numbers of Americans doubt their children will live better than they do. We'd like them to, but why should they? Other than technological improvements which doubtless will continue to make life better for everyone, why should our standard of living improve monotonically? And improve relative to the rest of the world? Certainly the advantage in this regard can shift to other countries, just as it shifted to us in the past.

The World's Highest Earners

One of the reasons for our high standard of living is the fact that Americans have been paid more for doing a given job than everyone else. This was fine as long as (a) the U.S. enjoyed the benefits listed on page one, and (b) significant barriers protected the status quo. But why should this go on? How can it go on?

Think about two cities. City A has more jobs than people, and city B has more people than jobs. Initially, people in city A – where labor is relatively scarce – will be paid more for doing a given job than people in city B. **The key to their continuing to earn more is the existence of barriers that prevent people from moving to city A.** Otherwise, people will move from city B to city A until the ratio of people to jobs is the same in both cities and so are the wages. **Among other things, geographic inequalities are dependent on the immobility of resources.**

For much of the last century, barriers kept our pay high. Other countries' output wasn't as good as ours. Some lacked investment capital, and some were decimated by war from time to time. Perhaps they didn't possess our ability to generate technological advancements or our managerial skills. High transportation costs, tariffs, prejudices (when I was a kid, "Japanese transistor radio" was synonymous with "low quality") or legal restrictions (e.g., keeping foreign airlines from competing freely in our markets) may have protected American wages. International trade wasn't what it is today. But all of these things can change over time, and it's hard to see how the earnings supremacy of U.S. workers will be sustainable.

Among other things, our legacy airlines became weighted down with high-cost labor contracts and all have gone through bankruptcy to shed them. Likewise, high healthcare costs added to the cost of every car built in the U.S. to an extent that hurt our competitiveness. Thus the U.S. auto industry lost domestic market share, sent production overseas, and consists of three companies of uncertain creditworthiness.

Protectionism favors the erection of trade barriers, but it's usually resisted based on the totality of its effects. **In international trade, just as in local markets, the only real way to maintain and grow market share – and thus to protect earnings power – is to offer the best combination of price and value. Regulations and tariffs won't make us competitive in the long run, and without offering a superior bargain, the supremacy of our standard of living will not be preserved in a world of lower barriers.**

What Do You Make?

We're all familiar with the pattern: as communications improve and barriers and transportation costs come down, jobs move from the U.S. to China, India or some other low-cost country, spurred by producers' desire to increase profits or just remain competitive. There's even a word for it: outsourcing. As a result, with each passing year, the U.S. manufactures less of its needs and the world's.

I looked at myself on the way to work this morning. Everything I had on was made outside the U.S.: suit, shirt, tie, shoes, eyeglasses, even underwear. My car, TV and stereo are imports. So's my computer. I bought some of these things from American companies, but they were made elsewhere. (I don't think I'm unpatriotic in buying these things: I'm just pursuing high-quality goods at the best ratio of value to price.)

There's no way around it: we don't make much anymore. What does that mean? I have to admit I don't know. I'm not enough of an economist to have the answer. But I wonder a lot about how an economy can function if it doesn't make much.

Joe does Ed's legal work, and Ed keeps Joe's books. Sarah cuts Bob's hair, and Bob cooks in the restaurant where Sarah eats. Rich drives the bus that takes Sue to the bank,

and Sue handles Rich's loan application. And, of course, someone like me manages investments for all of them. But how does an economy function if nobody actually makes anything – and if we have to buy all of our stuff from other countries? I'm exaggerating for impact, but you get my meaning. We make less and less each year – and we consume more.

Can an economy be successful if it consists of nothing but service providers, government workers and retailers? (Think about the unions you hear the most about in connection with the upcoming presidential election: the Service Employees International and the American Federation of State, County and Municipal Employees – no longer the Teamsters and Auto Workers.) Can a nation prosper without producing goods? I just don't know the answer.

And then there's the question of where we'll get our stuff from. Of course, we'll buy it from other countries. **But that leads to other questions: To what extent will rising inflation in cheap-labor countries raise the cost of the imports on which we depend so thoroughly? What will we sell to the rest of the world in order to get currency with which to buy their stuff? And for how long will they buy it from us?**

Certainly American goods have become less price-competitive, and other countries have learned to produce for themselves. Think about what we export. Movies? Computer software? Other countries are increasingly making their own. Financial products? Now there's an area where we're still exporting. But given the results with subprime and CDOs, might we have damaged that franchise? (Here's a piece of trivia for you: what's our biggest export by volume? This trick question hinges on the inclusion of the words "by volume," and the answer is waste paper for recycling. Certainly this doesn't indicate a manufacturing advantage on our part, or value we're adding to the global economy.)

Increasingly, we're reduced to designing products, styles, software and media content for production elsewhere. What's the long-term outlook in that regard? How long will others need us in that role? It's been said we're becoming a nation of burger flippers. An exaggeration, certainly, but how much of one? And what are the ramifications? One last thing (and don't tell my friends I said this): **What does it mean when investment bankers and money managers – who add relatively little to economic output – are among a society's highest paid members?**

Earning and Spending

When I meet with people in other countries, here's how I describe the typical American (again, exaggerating for effect): \$1,000 in the bank and \$10,000 owed on the credit card; makes \$20,000 a year after taxes and spends \$22,000. That may not be strictly accurate, and I haven't checked my facts. But I think it presents the general picture.

Many people have little if anything saved up – we often read about people being bankrupted by a bout of sick leave – and the savings rate has fallen to roughly zero.

People probably think of their pension plans, IRAs and home ownership as eliminating the need for savings. But certainly recent events have shown the holes in that approach.

U.S. consumers increase their debt continually, seemingly without ever thinking about paying off the balance or of how they might accomplish that (short of winning the lottery). It doesn't seem to trouble people when they spend more than they earn, whether through the use of credit cards or by taking out loans, including borrowing and spending the equity in their homes. In all of these regards, the American consumer doesn't seem to give any thought to how this movie will end (I last raised this in "Hindsight First, Please" in October 2005). **It's just a matter of people wanting to consume more than their income supports. Saying "I want it, but I can't afford it" seems hopelessly old-fashioned in the America of today.**

Who Else?

I wish only consumers acted this way. Go back three paragraphs, though, and ask whether my description of the typical American doesn't also relate equally to our government: constant deficit spending and continually increasing debt.

Our fiscal deficit and national debt aren't enormous relative to other developed nations and to our GDP. And I don't make a value judgment that it's wrong to run deficits from time to time. The traditional view of fiscal policy is that deficit spending should be used counter-cyclically, expanding it in weak times to stimulate the economy, and contracting it (perhaps paying down debt) to throw on some cold water when the economy becomes heated. **But I wonder whether constant deficits, and a national debt that always grows faster than GDP, can be right in the long run.**

Right now, the U.S. Treasury has to borrow to cover our fiscal deficit. As the debt grows, the interest bill rises – and in connection with the rescue of Fannie Mae and Freddie Mac, Congress just approved an increase in the national debt ceiling from \$9.8 trillion to \$10.6 trillion. Pretty soon, we may have to borrow just to pay the interest.

Might we ever pay off our debt? How? More importantly, what are its ramifications? Dependence on foreign lenders puts us in quite a box:

- To attract foreign capital, it's better to pay high interest rates. But the need to keep them high could complicate the job of stimulating our economy when it slows.
- The fact that our negative balance of payments pumps excess dollars into circulation abroad can put downward pressure on the value of the dollar.
- Weakness in the dollar can make foreigners reluctant to hold reserves in dollars, and to buy Treasury debt that will be repaid later in dollars that buy fewer goods. What happens when we pump out so many dollars – and they depreciate so much – that foreigners refuse to accept our promises of payment? How then will we fund our deficits?

This debate has gone on for years. Our politicians want to borrow so they can continue to spend more than comes in via taxes. But shouldn't we ask what amount of debt is right to leave for future generations? As the federal deficit grows relative to GDP, so will the national debt, and future generations will be saddled with an increased interest burden (even if there's never a need to repay).

Again, I'm not enough of an economist to know the answers. (And even economists disagree about the significance of national deficits and debt.) **But I wonder whether it's prudent for a country to spend more than it makes in both good times and bad.**

Affording Retirement

In college macroeconomics, I learned that Social Security was one of the important components of the "safety net" preventing a recurrence of the Depression. With help from their personal savings and the private pension system, Americans would be able to afford retirement, rather than end up on the streets in their old age.

Now I worry about the outlook for my fellow Americans in this regard. Many have little saved, as I mentioned above. According to Tom Friedman, writing in *The New York Times* on June 29, "[Since 2000,] our national savings have gone from 6 percent of gross domestic product to 1 percent . . ."

The defined benefit pension system is shrinking, especially with regard to new enrollments. Defined contribution plans and IRAs replace it somewhat, but their voluntary nature leaves big holes in the safety net. (I admire the wisdom of mandatory pension plan participation in countries like Australia, Denmark and the Netherlands; people can find it hard to save rather than spend, so it's a good idea to give them "encouragement" in that regard.)

Finally, the impending shortages in the Social Security System have been very well documented, and the best the optimists can say is "it won't be a problem anytime soon." Add in more years spent in retirement by people living longer and a declining ratio of workers paying into Social Security to retirees drawing out, and the outlook is very problematic.

Will large numbers of Americans be unable to afford retirement? Will they experience deprivation? Will they become a burden on the community and the nation? I see no easy or pleasant answers to these questions.

The Healthcare Dilemma

Healthcare is another example of a problem crying out for a solution, but the stumbling blocks are many.

- Healthcare is expensive, and the cost rises all the time, in part because costly new medicines and procedures are developed.
- Americans are living far longer, so there are more years in which sickness is high and costs are elevated. In the modern era, few people (understandably) are content to slip into decline and death without a fight.
- Remarkably in our advanced society, nutrition and health awareness seem to be going in the wrong direction, along with the level of exercise for large portions of the population. Obesity has become an epidemic, bringing with it serious health problems.
- Patients want the best care, and doctors want to provide it. How can society respond to this demand when many patients can't afford the care, or even a reasonable co-payment? I once read a *Wall Street Journal* op-ed piece on healthcare with a title something like, "If You're Paying, I'll Have Steak." That's the inevitable outcome when third parties foot much of the bill.
- It's hard to effect triage: who'll tell an 80- or 90-year-old that he shouldn't get a joint replacement or costly drug therapy? If a hospital or the insurance company wants to say "no," all hell breaks loose.
- The economics of medical care have become somewhat anti-social. Doctors face declining pay and status, and systems designed to control healthcare costs stick healthcare professionals with very distasteful administrative burdens.
- Amazingly for such a rich nation, statistics rank American healthcare low in the developed world. (I'd guess, however, that this is the result of averaging a lot of people enjoying very good treatment with the less fortunate who fare much worse than their counterparts in countries with broader government-sponsored programs.)
- One answer is some form of socialized or universal healthcare, but by nature such a system is likely to be costly, bureaucratic and/or ineffective. Other countries have national health systems, but it's hard to get appointments, and I imagine everyone gets care that's okay but not great.
- If there's a collective scheme, can the healthiest and wealthiest be forced to participate? If not, how will it function if they opt out of it, pulling away healthcare resources for "concierge" medical service and draining low-burden members from the pool of insureds?

Taken together, these points suggest possible compromises but no ideal answer. **The bottom line is that we can't afford to give the best possible medical care to every citizen. No country can, and anyone who says we can is probably running for office.** We can either (a) give moderate care to everyone or (b) retain a system under which the results are all over the map and the less fortunate get very little. Neither of those is perfect, but I think they're the choices.

Growing Inequality

The capitalist system produces gains because of a Darwinian process in which participants are spurred on by economic incentives and the most successful enjoy great rewards. The system runs on the ability of those who are more talented and/or work

harder to do better than others. Inevitably the better life also goes to some who are undeserving and just lucky or born into wealth; that's undesirable but inescapable. But it's not good if the margin by which some do better than others is too big.

I think it was in the '70s that I came across a great explanation for America's economic success:

When the English factory worker sees the boss drive out in his Rolls Royce, he says, "I'd like to put a bomb under that car." But when the American worker sees the boss drive out in his Cadillac, he says, "I'm going to own a car like that some day."

That's one of those little stories containing a great deal of truth. **Economic motivation and a feeling of opportunity are great positive forces, while class resentment is equally negative. We want America to remain a meritocracy where all citizens believe in their ability to get ahead.** Too much of a disparity could eat into the belief in our system.

Pay at the top has exploded relative to all else. At Citibank in the mid-1980s if my memory's correct, CEO Walter Wriston, the world's top banker, made about \$250,000 a year. Twenty-five years later, the CEO of a money-center bank or large corporation makes 50 to 100 times that . . . and 400 times in a year when options pay off big. What other segment of our workforce has done as well? We're in a period of general income stagnation, when lots of Americans haven't made strides like the executive class . . . or any strides at all.

I don't expect executives to indulge in self-restraint, since people rarely do things against their own short-term interests. But I'd like to see boards take the position that huge incomes should come only with great benefits for the companies' owners. And that a single great year might not merit enormous compensation that year. Entrepreneurial rewards can be appropriate for successful executives, but they should come only for long-term success and should be at risk in the event of failure.

I believe thoroughly in the free market system, and that the worst thing imaginable would be government regulation of salaries or incomes. But I also worry about the consequences when the benefits to the fortunate few are perceived by everyone else to be unfairly disproportionate and unrelated to achievement.

In the past, in addition to the fact that incomes weren't so enormous at the top, the income gap was narrowed by the fact that people could do pretty well at the bottom. Millions of menial and blue-collar jobs were created as our economy expanded.

Even without much education, people could enjoy the good things in life, including cars, TVs and vacations, along with good public school educations for their kids and the possibility that most of those kids would have better jobs than their parents. Which of those elements is equally true today?

In the “Information Age,” the lack of a college degree or computer literacy is a much greater handicap than it used to be. With non-information jobs increasingly moving overseas, what jobs will our less-educated citizens occupy? You might say education holds the answer, but (a) our public education system is in decline, and (b) how, especially given these jobs’ greater productivity, can there be enough tech-based jobs to keep our entire population gainfully employed?

The Energy Problem

When I began to drive in 1964, oil was \$4 a barrel and gasoline was 29 cents a gallon. Then, in 1973, OPEC put an embargo on oil exports. We saw lines around the block at gas stations, and we were permitted to fill up just every other day. The price of oil jumped to \$35 by 1980 or so, and then it subsided. It spent the period from 1986 to 2001 between \$10 and \$30 before going on to hit \$92 in 2007 and \$148 earlier this year.

The bottom line, however, is that from about 1880 until a few years ago, we were in an environment of cheap energy. **For over a hundred years, the price of oil didn’t rise, meaning it got dramatically cheaper in inflation-adjusted terms. This encouraged exactly the behavior one would expect: rapidly growing oil consumption, lagging increases in supply, little attention to the development of alternative energy sources, insufficient investment in mass transit, and weak efforts at conservation.**

We’re guilty of profligate energy consumption. Americans use SUVs or pickups capable of carrying eight people or huge payloads to do their grocery shopping. And they feel free to live 50 to 75 miles from work and to drive there alone in their behemoths. We just haven’t had incentives to use energy thoughtfully.

Maybe you have your favorite example of energy waste; mine is supermarkets’ removal of doors from their freezer displays. Can you imagine what future archaeologists will say about the decision to cool a whole store just to make it easier to buy some frozen food?

It’s not a coincidence that with oil much more expensive, Europe uses far less energy per unit of GDP than we do. Because of high taxes, gasoline traditionally has cost 2 to 4 times as much in Europe as it has in the U.S. Today it’s about \$9 per gallon, and yet I don’t hear Europeans complain much. That’s because they drive smaller, more fuel-efficient cars, live closer to their jobs, and make major use of mass transit. They even ride bicycles to work.

The most important element in responding to the energy problem is expensive oil. Low prices have encouraged high demand and discouraged additions to supply. The opposite will be the case only if prices are high. Politicians’ attempts to play to the crowd by artificially reducing the price of oil – through releases from the government’s Strategic Petroleum Reserve, banning “speculation” or providing a holiday from gas taxes, as was suggested in the spring by would-be presidential candidates from both parties – will do nothing but add to demand and depress supply.

In the future, pre-industrial societies will become industrialized, and millions of newcomers to the middle class worldwide will want cars. **We need an energy policy that is constructive for the long run, encouraging us to use less oil and find more.** Everyone's squawking about gas prices and looking for culprits. **But as long as gasoline costs much less than Snapple or Evian water, resources will be misallocated and we won't see real progress.**

We also would benefit from regulations that mandate fuel efficiency, encourage alternatives and penalize high oil use (or at least don't motivate the opposite). Business use of SUVs has been abetted over the years by tax rules giving them the superior depreciation treatment accorded trucks, based on weight. No doubt this was a result of lobbying on the part of auto companies enjoying the high profitability of SUVs. Thus it's been cheaper for businesses to use a \$30,000 SUV than a \$30,000 car. We and our government have to make more responsible decisions.

Finally, in order to make a genuine difference, we must invest on a vast scale in mass transit, energy efficiency and non-petroleum-based energy. This will have short term consequences: some combination of higher taxes, slower growth, reduced government spending in other areas, higher deficits and/or lower consumption levels. We can't spend to solve the energy problem and simultaneously avoid all of these effects. **Does the will exist to do these things in advance of the day we have no alternative?**

Rather than tap the Strategic Petroleum Reserve (which is designated for emergencies, and high prices aren't an emergency), we could add to it. **We could say, "Let's use less than all the oil that's available – and that we can afford – so as to leave some for future generations." But that requires selflessness and farsightedness that's far from in fashion.**

Who'll Own the World?

In addition to the practical and geopolitical ramifications of the energy situation, we'd better consider the financial ones. When the price of oil gapped up in the 1970s, vastly increasing numbers of dollars started to move offshore in exchange for oil. The process of bringing them back came to be called "recycling petrodollars." There are both benefits and risks in this process.

Earlier this month it was reported that our trade deficit declined in June because of rising foreign purchases of our products. That's one of the positive effects of the piling up of dollars abroad, and also of the fact that our goods priced in dollars look cheap to those outside the U.S. In short, we like having buyers for the things we have to sell.

But sometimes we resent their presence. It doesn't take much for xenophobia to rear its ugly head. In the 1980s, there was fear that Japan's economic juggernaut would lead to a wholesale takeover of U.S. assets by Japanese buyers. A couple of years ago, proposed

investments by China and Dubai in our oil and port industries were rebuffed, and last fall (before it was clear how desperately we needed more capital), people were grumbling about sovereign wealth funds' growing influence over our financial institutions.

Well, what do you expect to happen? If we spend more than we bring in, and thus send dollars overseas to pay our tab, isn't it reasonable to expect that some will be brought back and spent here? Clearly, the oil producers will have the ability to buy our assets. And some, like Qatar and Abu Dhabi, are far too small for the amounts involved to be invested or spent in those countries without making their inflation worse than it already is.

We're already seeing the effects. Financial institutions ran to sovereign wealth funds when they needed to add to their capital; who else is there? Room rates in hotels around the world are soaring in dollar terms. Powered by foreign buying, prices in the contemporary art market are moving out of sight, and so are high-end real estate prices in London and other cities of choice. Last month it was reported that a villa in the south of France had been sold to a Russian for \$750 million: **a great outcome for the seller, but also a sign that eventually we may be priced out of our own assets.**

With dollars moving abroad and exchange rates going against us, Americans are likely to find it harder to afford the goods and the standard of living they're used to, enjoy holidays overseas, and hold on to assets rather than succumbing to bids.

The numbers involved are very substantial. On July 10, *The New York Times* wrote:

With oil hovering near \$140 a barrel, analysts expect countries in the [Persian] gulf to generate yearly cash surpluses of \$300 billion . . . with sovereign funds in this area forecast to reach a size of \$15 trillion by 2020.

And of course, the numbers will do nothing but increase with time. The other day I was given a shorthand way to think about the situation: for every \$1 in the price of a barrel of oil at a point in time, approximately \$1 trillion will move from oil consumers to oil producers over the subsequent hundred years. **Oil at \$120 means the producers will reap about \$120 trillion. To put this into perspective, the total value of the world's stock markets currently stands at about \$47 trillion. So it's not much of an exaggeration to say the oil producers could own the world.**

You might argue that more fuel-efficient cars, electric cars, atomic cars, hydrogen power and cold fusion will alter the equation and prevent this massive shift of wealth. And we know for sure that high oil prices will reduce demand, encourage exploration and make invention and substitution economic. **But I think it's smarter to think about the issue than just count on things to work out.**

We're From the Government and We're Here to Help

Last month, in “Doesn’t Make Sense,” I labeled the obsession with the short term the worst thing about American business. But short-termism is far from limited to business. The process under which we’re governed is even worse.

In 2004, the *Los Angeles Times* asked me to write a review of Pete Peterson’s excellent book on the looming fiscal crisis, “Running on Empty.” One of his messages was that politicians are increasingly loath to take on the big issues of the future. Why should they? The prospects are unpleasant, and any solutions will entail pain. **What politician would trade away votes today to solve problems that are likely to come to a head long after he or she has retired?** As Peterson put it:

. . . while our problems are not yet intractable, both political parties are increasingly incorrigible. They are not facing our problems, they are running from them. They are locked into a politics of denial, distraction, and self-indulgence that can only be overcome if readers like you take back this country from the ideologues and spin doctors of both the left and the right. . . .

With faith-driven catechisms that are largely impervious to analysis or evidence, and that seem removed from any kind of serious political morality, both political parties have formed an unholy alliance – an undeclared war on the future. An undeclared war, that is, on our children. **From neither party do we hear anything about sacrificing today for a better tomorrow. In some ways, our most formidable challenge may be our leaders’ baffling indifference to our fiscal metastasis.** As former Treasury Secretary Larry Summers puts it, “The only thing we have to fear is the lack of fear itself.” (Emphasis added)

It doesn’t require higher math to see that we face serious problems in areas such as Federal deficits, the balance of payments, international competitiveness, energy, Social Security, Medicare and education. Certainly those problems won’t solve themselves. But when did you last hear of any serious debate on them?

Take the Social Security system. There are only four possibilities: (1) higher taxes, (2) lower benefits, (3) privatization, or (4) dealing with the system’s insolvency when it occurs. But the first two are unpopular, and the third is politically contentious, given that it’s inherently less egalitarian than the current system and could result in the government being on the hook as the payer of last resort. So that leaves the fourth . . . which is where we stay. **This just is not an acceptable approach to problem solving.**

Likewise, everyone knows the tax code is overly complex, indecipherable and larded with provisions benefiting special interests. It desperately needs reworking from the ground up, but no one considers that politically doable.

As *The Wall Street Journal* pointed out on June 24:

When President Clinton tried to overhaul the health-care system, he couldn't get even a committee vote on his plan in a Congress his party controlled. When President George W. Bush tried to revamp Social Security, he couldn't get even a committee vote on his plan in a Congress his party controlled.

Washington's failure to solve the big problems really gets me going, calling to mind a great quote from Will Rogers: "The more you observe politics, the more you've got to admit that each party is worse than the other."

Condemnation of politicians needn't be universal. There actually are some I like. More than anything else, they're marked by a spirit of bipartisanship. Rather than consider politics a blood sport in which the only important goals are to embarrass the other side and win elections, they want to solve our nation's problems. I just think they're few in number, and much fewer than I recall from my youth.

I confess that I feel the deck is stacked against government getting better. Less attention paid to newspapers and TV news, declining interest in national and international affairs, the rising role of the sound bite, generally shorter attention spans, a vanishing spirit of self-sacrifice, rising me-first-ism . . . where would optimism come from in this regard? We can hope, but I'm not that hopeful. The truth is that most people vote for the candidate who looks and sounds best in TV ads, who says what they want to hear, and who they think will put money in their pocketbooks today and brighten their lives tomorrow.

Imagine two candidates for president. One says, "I'm going to give you eight years of discipline and denial – of higher taxes and lower spending – but I'll leave the country in better shape." The other says, "I have a secret plan that will solve all of our problems without requiring any sacrifice on your part." Who do you think would win?

What Won't Work

There are no simple solutions to these issues. But that's not going to keep simple solutions from being demanded. Two areas where we're likely to see them tried are tax progressiveness and global trade.

A lot of populist rhetoric is coming from certain candidates for office this season, and if they're elected, they might try to redress the income disparity through tax increases at the top. As usual, they'll say, "We're not out to 'soak the rich.' We're just trying to make them pay their fair share." I don't know where the populists will go for their definition of a "fair share," but I'm pretty sure it'll turn out to be just a synonym for "more."

The result would be tax increases on people who – not according to value judgments, but in sheer economic terms – are our most productive citizens. Such increases aren't the answer, and they can affect the economy negatively. Back in Britain's low days in the 1970s, the top income tax rate was in the mid-90s (as was ours when I was a boy), and I read about a banker taking a week off from work to paint his house. The calculus was simple: it was cheaper for him to give up a week of after-tax salary than to pay the painter's bill.

Taxation creates incentives: to work less, to hide income and, ultimately, to relocate income to avoid taxes. When a professional finds it economically attractive to forgo his pay to perform a physical task, the net result is a loss for the aggregate economy. **This isn't the kind of incentive we should be presenting.** What supply-siders did in the 1980s was convince lawmakers of the effect of tax decisions on the operation of the macro economy. Their lesson mustn't be forgotten.

Likewise, trade barriers sound like an easy solution but don't work.

- Operating freely, global trade causes each good to be produced where it can be done cheapest and best. In this way, aggregate efficiency is maximized, and thus so is aggregate societal welfare. Actions that interfere with efficiency and the free-market allocation of resources invariably will have a negative overall effect.
- It's highly unlikely that we can raise barriers and tariffs against others without causing them to retaliate.
- A protectionist decision is just a choice among potential beneficiaries. A ban on imports of cheap clothing, for example, would protect the incomes of Americans working in the garment and textile industries but cause all Americans to pay more for what they wear.

As the last bullet point suggests, taxes and tariffs don't add value or make society better off; they merely represent decisions about how some elements in society are to be treated via-à-vis others. However, by interfering with the free-market allocation of resources, they're highly likely to detract from the overall economy. Bottom line: handle with care.

* * *

The more I think about solving problems, the more I believe one of the crucial choices is with regard to time frame. Short-term answers are very different from long-term answers. **America's problems are long-term in nature and require long-term solutions. There are things that can help in the short term but be counterproductive in the long term, and we mustn't let them get in the way.**

Take the earlier discussion of oil prices. We know high prices discourage consumption and encourage conservation, fuel efficiency, exploration and the development of

alternatives, and that low prices do the opposite. When people complain about high prices, vote-hungry politicians rush forward with short-term palliatives. **But quick fixes will do nothing but exacerbate the long-term problem, while short-term pain is probably an essential part of its solution.** In order to bring down oil prices in the long run, we need high oil prices in the short run.

Because gasoline prices were up, Americans drove 12.2 billion (or 5%) fewer miles in June than they did a year earlier. That was the eighth down month in a row. In other words, high prices made people treat energy like the finite and valuable commodity it is. High prices aren't pleasant, but eventually they could help get us to the desired result. **It's not for nothing that they say "no pain, no gain."** (And for this reason, the 20% decline in oil prices over the last six weeks shouldn't be viewed as an unmitigated boon.)

The short-term pleasure principle that seemingly governs today will make it challenging to implement disciplined and possibly painful solutions to the problems enumerated above, but they're the only way forward.

* * *

I hope you'll consider this memo constructive, and that it'll inform or inspire debate. The solutions to the problems I raise aren't obvious and won't come easily. But that's why these things must be tackled by skilled, apolitical problem solvers in and out of government. We need boldness, hard work and resolve from our leaders. **And we need officeholders capable of imagining outcomes worse than losing an election.** I can think of several.

We tend to lurch from crisis to crisis. In difficult times like today, we're too busy putting out fires to pay attention to long-term problems. And then, when the crises recede, people celebrate the return of prosperity and forget about the distant future and the big picture. **We'd all like to not have to face the problems I list. Indeed, we wish they didn't exist. But they do exist, and we must deal with them. And there can't be a better time than the present.**

August 28, 2008

P.s.: I always circulate my memos for comment before they're published, and this time I got a good one from Richard Masson. He's a very thoughtful guy, especially on bigger-picture matters – a bit of a libertarian, but also impossible to pigeonhole. I want you to have the benefit of his response:

The best thing about our country is the resourcefulness of our citizenry and the flexibility of our institutions and laws. Creative destruction and a functioning market economy assure change toward the best solution over time. I generally agree with all your observations and concerns, but I have faith in our ability to create (rather than impose or legislate) solutions over time. Perhaps America will enjoy a manufacturing renaissance, or the cost of oil will force communities back together and facilitate greater interdependence between neighbors? Perhaps a slowing economy will slow immigration and create job opportunities for our less educated citizens (and youngsters). Perhaps our best and brightest will gravitate toward engineering and science rather than finance. In many ways, the next generation could enjoy a higher quality of life even at a measurably lower standard of living.

I'd love it if Richard turned out to be right.

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Memo to: Oaktree Clients

From: Howard Marks

Re: Nobody Knows

The title of this memo isn't a joke; I mean it. Nobody knows the real significance of the recent events in the financial world, or what the future holds. Everyone has an opinion – there's an off-color joke to that effect – but opinions are entirely different from knowledge. As usual, the bulls are optimistic, the bears are pessimistic, and the rest are uncertain.

This is a great time for my favorite quote from John Kenneth Galbraith: "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." No one knows about the future, and that's more true now than ever . . . literally. Excesses were committed at financial institutions that we've never seen before in terms of their scale or their breadth, and many new inventions are in place that never existed before. So clearly no one can know how things will pan out.

My conviction that this is true frees me from having to methodically assess the strength and weakness of economies and institutions, and it permits me to limit my comments to what I consider strategic realities.

I'm flattered that people have asked for my opinion, and I will give it. But that's all it is: an opinion. In setting it down, I will repeat things I've written before. So if you find something that you think you're reading for the second time, you're probably right.

Boom-Bust

Those two words say it all. If you have a boom, eventually you'll have a bust. And the further the boom goes, the worse the bust is likely to be. If there's no boom, on the other hand, there needn't be a bust.

There was no great boom in the U.S. economy in 2003-07, and that's one of the reasons why it has held up reasonably well despite the recent turmoil.

But there was an incredible boom in the financial sector, and it has led to an incredible bust. (It remains to be seen whether its effects will slop over into the real economy. As you know, we think they will.)

Finally, there wasn't a boom in the U.S. stock market, and so it hasn't busted. (If you think your stocks have given you pain, realize that their decline isn't at all commensurate with the end-of-the-world thinking roiling the financial sector).

How Things Got This Way

Much of the current problem can be attributed to a decades-long bubble in the financial sector that made it the employer of obvious choice; attracted employees who were “the best and the brightest” (although often untrammelled by experience); contributed to greed and risk taking; drove out fear and skepticism; and carried institutions, behavior, expectations and asset prices to unsustainable levels.

What are the factors that got us in the current mess?

- Excess liquidity, which had to find a home.
- Interest rates that had been reduced to stimulate the economy.
- Dissatisfaction with the resulting prospective returns on low-risk investments.
- Inadequate risk aversion, and thus a willingness to step out on the risk curve in search of higher returns.
- A broad-scale willingness to try new things, such as structured products and derivatives, and to employ massive leverage.
- A desire on the part of financial institutions to supplement operating income with profits from proprietary risk taking – that is, to be “more like Goldman.”
- A system of disintermediation, selling onward, and slicing and dicing that caused many participants to overlook risk in the belief that it had been engineered away.
- Excessive reliance on rating agencies which were far from competent to cope with the new instruments, and on black-box financial models that extrapolated recent history.
- Unquestioning acceptance of financial platitudes without wondering whether altered circumstances and elevated asset prices had rendered them irrelevant:
 - Houses and condos are good investments and can be counted on to appreciate.
 - Mortgages rarely go into default.
 - There can never be a nation-wide decline in home prices.
 - It’s okay to grossly lever a balance sheet if you’ve hedged enough through derivatives.
 - It’s safe to borrow and invest funds equal to a huge multiple of your equity capital if the probabilistic expected value is positive, because “disasters rarely happen.”
- Individuals such as mortgage brokers and mortgage borrowers who were given incentives to do the wrong thing.
- Newly minted financial “masters of the universe” encouraged to maximize returns for themselves and their employers without concern for whether they were adding value to the financial system or endangering it.

In general, the above can be summed up as a shortage of adult supervision, common sense, skepticism, ethical concern and good old-fashioned prudence. As often happens in booms, the kids shouldered the adults aside or impressed them too much.

The list of errors can make you laugh . . . or cry. I mentioned in “Hindsight First, Please” how often financial people do things that look downright silly afterwards. But that never stops them from repeating the old mistakes or making new ones.

So now we find financial institutions that endangered themselves by using extensive short-term borrowings or deposits to make investments that turned out to be enormously risky when an unlikely disaster – a nationwide decline in home prices – occurred.

In many ways, changes in the environment contributed as well. They crept up one by one, unnoticed, but their combined effect is significant. For example,

- The Glass-Steagall Act was repealed, permitting banks and investment banks to combine. (It had been enacted in 1933 to outlaw such combinations because they were felt to have contributed to the Crash of '29. It's ironic – and certainly not irrelevant – that it was repealed in 1999, in time to contribute to the current credit crunch.)
- The rule limiting short sales to up-ticks was revoked in July 2007, enabling short selling to force stock prices down unabated.
- Derivatives were created whose prices were determined by the price of their “real” underlying securities; now we see that in an Alice-in-Wonderland way, they're able to influence the price of real securities (see below).
- And mark-to-market accounting exposed precariously leveraged institutions to the risk that technically-driven declines in asset values might leave them too weak to make it through to a better day.

It was during my working lifetime that the phrase “too big to fail” was coined. More recently, Citibank caused some people to observe that it had become too big to manage. In the current go-round, financial institutions have been described as too big to understand and, finally, too big to disentangle (given the proliferation of derivatives and swap transactions, a key element in assessing an institution's essentialness is the degree of counter-party risk it presents to others). There's no doubt that these developments are frightening. But heroes aren't people who're unafraid, but rather those who act bravely despite their fears. Investors mustn't let emotion control their actions.

Because of this combination of altered behavior, financial innovation and changes in the environment, I feel unable to tell you what lies ahead. But that doesn't mean I'm not going to suggest a course of action.

Does the Market Know?

For reasons both systematic and unsystematic, the market is in many cases taking its lead from . . . the market. Price declines cause fear, and thus further price declines.

In some cases, the signal for increased worry comes from increases in the price of credit default swaps, which provide insurance against debt defaults. Rising CDS prices imply that creditors have become more concerned. This can send down the prices of a

company's stock and debt instruments and frighten customers and depositors into withdrawing funds, potentially leading to downgrading and failure. In other words, increases in prices for credit insurance can serve as self-fulfilling prophecies. This is the unintended consequence of one of the recent innovations.

I want to mention the potential for manipulation present in this situation. One strong bid for default protection in the thin market for CDS on a given company can massively depress the price of billions of dollars worth of stock and/or debt. Clearly, an unscrupulous short-seller can use this tactic to his advantage. No one knows the extent to which it is in play . . . or how to stop it.

In the end, people once again have to apply skepticism and their own judgment, this time to bad news. Is the market smart or dumb? Is it giving us a valid signal to get out or the buying opportunity of a lifetime? I seem to remember a useful quotation to the effect that "The market is an ass." Thus I think there's more money to be made by being a contrarian than a trend follower.

The End of the Financial System

We're seeing and hearing things today that we never imagined.

- The demise or bailout of Lehman Brothers, Bear Stearns, Freddie Mac, Fannie Mae and AIG.
- Concern about the viability of Goldman Sachs and Morgan Stanley, and huge declines in their stocks.
- Rising prices for CDS protection on U.S. Treasury securities.
- Rates on short-term T-bills close to zero because of an extreme flight to safety.
- Awareness for the first time, I think, that the U.S. government's financial resources are finite, and that there are limits on its ability to run the printing press and solve problems.

Will the financial system melt down, or is this merely the greatest down cycle we've ever seen? My answer is simple: we have no choice but to assume that this isn't the end, but just another cycle to take advantage of.

I must admit it: I say that primarily because it is the only viable position. Here are my reasons:

- It's impossible to assign a high enough probability to the meltdown scenario to justify acting on it.
- Even if you did, there isn't much you could do about it.*
- The things you might do if convinced of a meltdown would turn out to be disastrous if the meltdown didn't occur.

- Most of the time, the end of the world doesn't happen. The rumored collapses due to Black Monday in 1987 and Long-Term Capital Management in 1998 turned out to be just that.

* -- Money has to be someplace; where would you put yours? If you put it in T-bills, what purchasing power would be accorded the dollars in which they're denominated? If the government's finances collapsed, what good would your dollars be, anyway? What depository wouldn't be in danger? If you and many others decided to put billions into gold, what price would you have to pay for it? Where would you store it, and how would you pay for the truck to move it? How would you spend it to buy the things you need? What would people pay you for your gold, and what would they pay you with? And what if you bought credit insurance on all of your holdings: who would be able to make good on your claims?

No, I don't see any viable way to plan for the end of the world. I don't know any more than anyone else about its probability, but I see no use in panicking.

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?

What Kind of Future Do We Face?

Of course, even assuming there will be a recovery, we have to think about what it will look like. As I wrote in "Doesn't Make Sense," we aren't counting on a "V." We will continue to emphasize companies that we feel serve basic economic functions and can do relatively well even in bad times. Many elements in the economy are being damaged, especially confidence, and they may take a relatively long time to recover. In particular, the mechanism for providing capital is in great disrepair, and less credit certainly means a slower recovery and less growth.

The financial institutions deserve a special mention. If there's ever been a sector that's down-and-out, this is probably it. Nevertheless, Oaktree generally demands more transparency in order to invest than most of them provide. It can seem almost impossible to ascertain their condition through due diligence, and absolutely impossible without access to their books. For example, possible buyers probably found the risks at Lehman Brothers to be unanalyzable. As *The Wall Street Journal* said on Tuesday,

Even understanding Lehman's current trading positions was tough. Lehman's roster of interest-rate swaps (a type of derivative investment) ran about two million strong . . .

What kind of effort would it require to understand the significance of two million derivatives positions: are they thoroughly hedged, or bullish or bearish on balance? And what about Lehman's millions of other derivatives and complex securities? This opacity, combined with heavy leverage, reliance on short-term funds, liquidity and conscious risk taking, is the reason why a loss of confidence is conceivable at any financial institution in times of panic.

What will the Wall Street of the future look like? We read – and I don't doubt – that for at least a while it will be smaller, less leveraged, less profitable, and more highly regulated. But I also think it will be less competitive and less risky.

In the course of my career, Wall Street went from being (1) brokers handling riskless trades for commission to (2) dealers buying and selling inventory for a spread to (3) block traders purchasing large amounts of stock when market liquidity was inadequate to (4) proprietary traders risking their own capital in pursuit of profit for the house. Backing down this progression wouldn't be the worst thing in the world.

What Will Start the Recovery?

Eventually, someone will walk out of the crowd and take advantage of the lows. He may start an investment bank unburdened with a legacy of losing positions. Or a bond insurer like Warren Buffett did when MBIA and Ambac became impaired. **The cause of the recovery can't be predicted. There may not even be a visible one. Maybe things will just get so cheap that they can't stay down.** (In ancient history – November 2001 – I wrote “You Can't Predict; You Can Prepare,” with a thorough description of how cycles happen, based on energy all their own. It might be worth digging up.)

I like to point out that, even in retrospect, no one can say what started the collapse of the tech stock bubble in 2000. But it did start . . . just, I think, because stock prices rose far too high. That works in reverse, too.

In March, in “The Tide Goes Out,” I mentioned the three stages of a bull market, a notion I've been carrying around in my head for about 35 years:

- 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.

As we all know, buying during the first stage can be highly profitable, while buying during the last euphoric stage usually leads to disaster.

Then I went on to create the converse of the above, 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.

In the final stage, you can buy assets at prices that reflect little or no optimism. There can be no doubt that we are in the third stage with regard to many financial institutions. Not necessarily at the bottom, but in a serious period of unremitting pessimism. **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.

Everyone was happy to buy 18-24-36 months ago, when the horizon was cloudless and asset prices were sky-high. Now, with heretofore unimaginable risks on the table and priced in, it's appropriate to sniff around for bargains: the babies that are being thrown out with the bath water. We're on the case.

September 19, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: Plan B

Over the last decade or two, Plan A consisted of relying on the free market to maximize economic growth and efficiency (as described in “The Aviary,” May 2008). What can we say about that? Oops? We don’t hear much at this moment about market efficiency, or about the proposition that it would cause complex mortgage-backed securities to be priced right.

So now we have Plan B, better known as TARP, the Troubled Asset Relief Program. On the heels of other injections of capital by the U.S. Treasury and Fed and central banks elsewhere, it was proposed on Friday that up to \$700 billion be spent to purchase “toxic” mortgage securities from financial institutions that are weighed down with them.

Ya’ Gotta Believe

Those who have more money than they need lend it to those with use for more money than they have. This process is called providing credit. The movement of credit puts otherwise-idle money to work and thus adds to economic output. Economies run on credit.

According to Merriam-Webster, the word “credit” is derived from the Latin *credere*: “to believe, entrust.” We provide credit when we believe in borrowers and trust that they’ll pay us back (although we believe in some more than others and charge the latter more interest). Further, the entire economy runs on trust: that the people to whom we provide goods and services will pay their bills; that contracts will be adhered to; and that money will retain value, or at least the part that inflation doesn’t erode.

Belief is what makes the economic world go round. Take a minute to think about how we would behave in a world in which there wasn’t trust in money, the institutions that store it and the mechanisms that move it from one place to another. Clearly, we’d be sunk without trust in the financial system.

I’ve described in the past how financial institutions are vulnerable to loss of faith because of their unique combination of opacity, leverage, conscious risk bearing, and their use of short-term deposits and borrowings to fund longer-term, illiquid assets. When providers of capital lose faith in a financial institution, they line up to withdraw their money. But the institution can’t give them all back their money, because it can’t liquify all of its assets immediately. Attempts to do so increase the downward

pressure on asset prices, further weakening financial positions and reinforcing the loss of faith. And thus the circle becomes vicious and we have a “run on the bank.”

We saw many runs on banks during the Great Depression; the result was the introduction of federal deposit insurance. We also saw a bank run in the U.K. last year, when depositors lined up at the Northern Rock building society until the Bank of England calmed fears by guaranteeing all deposits. (I had money there, and believe me, absent the guarantee, the 2% penalty for early withdrawals would have been powerless to dissuade me from moving the remaining 98% to a safer institution. Take a few hundred or thousand of me, and you have a run on the bank.)

In short, the government is attempting to prevent a loss of belief. Is such a thing possible? Ask yourself whether eight months ago you thought possible this year’s developments at Bear Stearns, IndyMac, Lehman Brothers, AIG, Fannie Mae and Freddie Mac. To some extent, they all stemmed from a loss of faith.

The Source of the Problem

There are two principal fundamental causes behind the events we’re seeing. The first is the huge losses in complex mortgage-backed securities. As I’ve written before, the issuance and purchase of these securities resulted from the following confluence of factors:

- Quest for return, decline in risk aversion and lowering of skepticism.
- A boom in home prices and a belief that they couldn’t fall back *en masse*.
- Securitization and selling onward of debt – which eliminated lenders’ hesitance to lend and led to a process in which everyone profited when a loan was made.
- Thus an increased willingness to lend higher percentages of the skyrocketing prices of homes, even where the borrower couldn’t demonstrate creditworthiness.
- Widespread use of leverage (because the risks were underrated) and complexity in fashioning mortgage-backed securities.
- Massive shortcomings at rating agencies that erroneously described the resulting securities as investment grade, and sometimes even “super senior.”

In this way, enormous amounts of overrated securities came to the market. They went to financial institutions that didn’t understand the riskiness of what they were buying and thus permitted themselves to become vastly overleveraged.

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.

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.

The second fundamental factor leading up to the current mess was the creation of the vast market in derivatives, especially credit default swaps (CDS). In the current decade, CDS came into broad use as a mechanism for insuring against defaults. For an up-front fee and an annual premium, holders of debt could get someone else to promise that they'd buy that debt at face value in the case of a default or other "credit event."

The buyers of CDS accepted at face value that the writers of the insurance would pay if there was a default. For this reason, because Bank A had bought insurance on Company X's debt from Hedge Fund B, it considered it safe to sell insurance to Bank C. **But what if X defaults and A has to pay C but can't collect from B?** There's over \$60 trillion of CDS outstanding, and a lot of it is well hedged in theory; thus the net exposure to defaults if everyone pays might be rather small. But if some counterparties are unable to pay, institutions that bought insurance from them (or from others that bought from those institutions) might fail to receive billions in payments. Consider it one big daisy chain. It's probably because of its position as a counterparty that Bear Stearns wasn't permitted to fail in March (while Lehman was cut adrift this month when its failure was judged to be bearable).

Of course, these two developments have been complicated by (a) the fact that no one can reasonably say what the home underlying a mortgage is worth (the intrinsic value of a non-cash-producing asset is a useless concept in the short run), (b) the fact that no one knows how the credit swap market will function in a crisis, and (c) their own sheer magnitude. The sum of the foregoing has the potential to place in jeopardy any financial institution that lacks federal backing. It's for this reason that the government has assumed the liabilities of Fannie Mae and Freddie Mac, lent money to AIG, accepted Goldman Sachs and Morgan Stanley as bank holding companies (with permanent access to Fed borrowings), backstopped money market funds, and now proposes to purchase \$700 billion of mortgage securities.

Does Ben Know Something We Don't?

I cited the above headline in "Now What?" last January. That's what *breakingviews.com* asked about the Fed's September 2007 decision to cut rates by 50 basis points rather than the expected 25. Clearly Fed Chairman Ben Bernanke thought the circumstances called for stronger medicine than most observers.

Now it's clear that both Bernanke and Treasury Secretary Hank Paulson envision possible consequences justifying the strongest possible action. Last weekend, for example, Paulson said in an interview, "I don't like the fact that we have to do this. I hate the fact that we have to do it. **But it's better than the alternative.**" (Emphasis added)

What is the alternative? As I suggested last week in "Nobody Knows," there really is no outcome so negative that it can't be imagined. That doesn't mean terrible things will happen if no action is taken, but the possibilities are there, causing fear. Obviously, Bernanke and Paulson feel some of them could come to pass, and I respect their opinion.

So what is that alternative Paulson alludes to? Cascading bank failures? Interlocking dependence on counterparties in the derivatives markets who lack the ability to make good on their liabilities? Ultimately, reduced faith in U.S. Treasury securities and the dollar? As I said last week, I don't know. But it's not unreasonable to respect these possibilities. Our leaders want to justify the strongest action in history without spooking the market by enumerating the possibilities, so they're not being too specific. The Great Depression is our only model. I believe it justifies strong action.

Let me take a moment to say we're enormously lucky to have the right team in place at this time. Bernanke is a highly respected academic expert on the Great Depression, and Paulson is the very successful practitioner who chaired Goldman Sachs, an institution for which I have enormous respect. Being human, they're unlikely to get it all right. But I can't think of anyone I'd rather have in their jobs.

The Plan and the Stumbling Blocks

The plan is simple. In fact, to some it's too un-bureaucratic to be acceptable. The Treasury will use up to \$700 billion to purchase the most toxic mortgage-backed securities from financial institutions – both U.S. and foreign – that do business in the U.S. This will reduce the doubt about the institutions' solvency and, in place of unsalable assets, give them cash they can lend. No external oversight or internal process is specified, and the result will be immune from examination by other authorities and from litigation.

Having described the plan in one paragraph, it'll take much more space to discuss the complaints being voiced and the obstacles in its path.

- We're asked to trust the judgment and integrity of the Treasury Department. I find this a pragmatic and direct solution. Others more skeptical than me disagree. Some think Paulson will be biased in favor of Goldman Sachs and the rest of Wall Street, but I'm convinced he took the job out of *noblesse oblige* – not for money or fun, I think – and I trust him to do his level best.

On that subject, let me share a little history. Fifteen years ago, the staff of the Resolution Trust Company asked if we could help them achieve fair prices in disposing of the assets they'd taken on from failed S&Ls. I outlined a plan under which brokers would be asked for bids and we would watch the brokers, judging the adequacy of those bids. **"But who'll watch you," they asked.** My reply: "I've got bad news: you're going to have to trust someone." I'm perfectly happy trusting the Paulson-led Treasury.

- In a similar vein, some are complaining about the lack of supervision in the plan. The *Financial Times* quoted Barack Obama as saying, "We cannot give a blank check to Washington with no oversight or accountability . . ." Well, for my part, I'd rather entrust power to one wise man than a committee or bureaucracy consisting of average people. I think Paulson is that one wise man, but I'm also sure he's smart enough to surround himself with others who are equally capable.
- What will the marching orders be? In particular, what sort of prices will be paid? Fair market prices or higher? First of all, it's almost impossible to come up with a fair or "market" price for many of these assets today. Second, paying just the market price in the current highly depressed market wouldn't do much for the institutions' net capital position. But third, if more than the market price is paid, that'll be seen as a "giveaway to Wall Street." **It has to be made explicit – to those expected to approve the plan, and certainly to those expected to carry it out – whether these will be straight sales at market or they'll include a subsidy.** I think a bunch of the latter is called for.
- **Even beyond the points listed above, another issue may present a bigger stumbling block. The greatest reluctance may relate to the fact that, under the plan, when the process restores the viability of institutions that now are burdened with negative book value and inadequate confidence, the immediate financial benefits would go to shareholders and executives who either participated in the creation of the problem or, at any rate, should be penalized for the companies' failings.**

To solve the problem, some say that in exchange for taking securities off institutions' hands – especially at above-market prices – the government should get ownership positions in those institutions. But how much? What would be the proper quid pro quo? If a \$1 billion purchase of debt at \$200 million above market saved a \$15 billion institution, what piece of the company should the government receive? Do we want the government owning large pieces of private companies, or running them? And would that ownership stake then put the government in a conflict position vis-à-vis the institutions where it's not an owner? This is obviously a complex issue, and I'd hate to see it delay the solution of the problems we face.

Further, there are calls for requiring executives at the institutions involved to accept limits on their compensation. What could be worse than setting up reasons for people to hesitate before reaching for this lifeline?

- Certainly politics will be a major factor in whether the plan is enacted and in what form. In that regard, **there couldn't be a worse time for this to be debated than six weeks before the election.**

After being well ahead in the polls until late August, Barack Obama lost his lead when the Republicans held their convention and made Sarah Palin their vice presidential candidate. But last week, when the economic crisis exploded and John McCain described the economy as strong, the Democrats pulled back into the lead. That's not lost on them, and I'm sure they'll continue to use the issue to maximum advantage. They'll complain about the one-sidedness of the Wall Street bailout and demand something for "the rest of us," like further economic stimulus, direct relief for mortgage borrowers, and loans to the auto makers. This politicizing might delay the process, encumber it with baggage, or make it unattractive to its supporters.

Democrats will attack the plan to make Republicans look bad, and conservative Republicans may resist it as an unwarranted extension of the government's reach. In the end I feel it'll pass, but who knows in what form.

I don't view the plan as mainly a bailout for Wall Street and fat cats. Saving the financial system will benefit all users of capital, including home buyers and auto makers. Of course, that may sound like "trickle-down economics," which some are happy to rail against.

I think federal ownership would be a very hairy matter. But in this case I do have a solution, at least regarding the prices at which the government resells the debt: **Why not simply say that the government should receive half of the buyers' return in excess of a 20% yearly rate,** or some such? Ownership would present challenges, but sharing in the benefit would not.

Who's In the Wrong?

There'll be cries for scalps, and politicians will play to the crowd by assigning blame. This should be primarily a side-show, but it can grow into a significant distraction.

Short sellers are in the crosshairs most prominently. It is a simple fact that ever since the up-tick rule was revoked fourteen months ago, short sellers have had the ability to drive down stock prices, which they couldn't do if a short sale could only take place at a price higher than the last trade. It's also a fact that some financial stocks have fallen, and that their declines have added to worries about the companies, inducing further declines. Of course, no connection between the two has yet been proved.

As a result of the recent market action, short selling was outlawed in roughly 800 financial stocks, including outliers such as General Electric. This action was coincident with last Friday's rally, and people breathed a sigh of relief. Had short sellers been

responsible for the demise of Lehman? Should short selling be banned? As usual, the answer isn't clear.

Balancing out the simple truths stated above, a number of factors argue in favor of short selling or against a ban:

- Short selling isn't "worse" than outright buying. One makes stocks go down; the other makes them go up. Why is shorting – selling what you don't own – any worse than buying what you don't own?
- Short selling is a highly legitimate way for investors to act on their belief that a stock's price is too high. Thus it tends to help stocks sell at fair prices.
- Short selling can bring losses to those who hold stock, but unabated buying can force stock prices to too-high levels where no one should buy. What can we do to prevent injury from purchases during unjustified booms?
- **Sure you can keep stock prices from being forced down by outlawing short selling. But then why not outlaw all selling? Think of what that would do for stock prices!**

In the short run, protecting the financial system is more important than preserving market efficiency or heeding the above arguments. Thus I do not think it was a mistake to ban short selling for the time being.

In the long run, however, I feel a ban on short selling is not in order, although I consider it desirable for the up-tick rule to be brought back.

Finally, as with many other things, the real problem isn't with short selling, but with abusive short selling. Manipulating the market to make short positions profitable by spreading negative rumors or bidding up CDS (see "Nobody Knows" from last week) should be driven out . . . although doing so won't be easy.

* * *

The trouble with memo writing at times like these is that there's always more. But this is a good time to wrap up regarding the Treasury's plan. My conclusions are as follows:

In the period 2003-07, the government, and especially the Fed, stimulated the economy and the financial system when they should have been acting restrictively to curb excesses. On the contrary, stimulation is in order today to prevent serious damage. I think we're going to get it.

But I also expect to see a rising tide of regulation of financial institutions in the period ahead, and I don't think restrictiveness will be the right thing until the system is on a firm footing. It's widely agreed that the authorities contributed to the severity of the

Depression by withdrawing liquidity when they should have been increasing it. Let's not tighten again.

In "Doesn't Make Sense" in July, I listed four things that have to happen in order for the trends in mortgages and financial institutions to turn positive:

- Home prices have to stop going down.
- Home mortgages have to be made available.
- Financial institutions have to stop experiencing incremental write-offs.
- Financial institutions have to be able to raise additional capital with which to rebuild their balance sheets.

I also pointed to the complication: that each of these four things is dependent on the occurrence of another. **The good news is that the Treasury plan has the potential to break into the cycle of negativity, directly address the third and fourth of these, and thus contribute to the first and second. That's why I'm all for it.**

In the Depression, the engine of capital provision went into a long-term stall, and we know the consequences. The attempt now is to jump-start processes that have stalled and prevent the rest from doing so. I'm sure this is the right thing to do, and I hope for its success.

September 24, 2008

P.s., In "You Can't Predict. You Can Prepare." (November 2001), I described the process through which stock markets pull out of declines and turn upward:

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.

In the latest development, it was announced yesterday that Berkshire Hathaway would invest \$5 billion in Goldman Sachs stock. Warren Buffett exemplifies the kind of person who can step out of the crowd. **Perhaps his example can make a few more people stop worrying about losing money and start worrying about missing out on gains.** One of these days, that'll happen, and things will turn for the better.

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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

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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?")

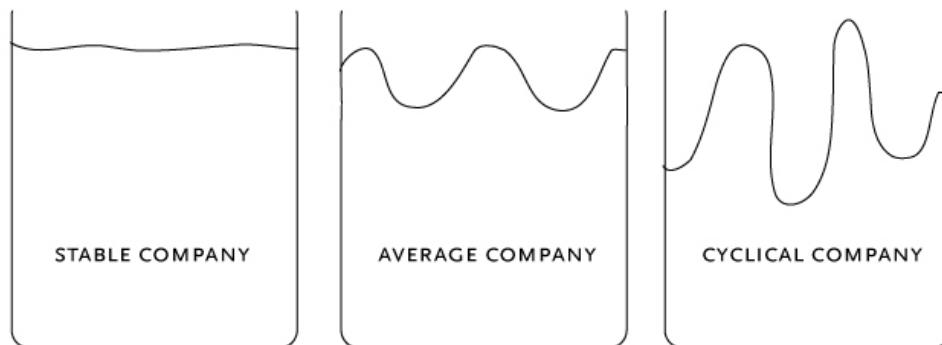
This time around, assets are evidently so rotten in so many places that no financial institution wants to risk doing business with any other financial institution without a government backstop.

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.

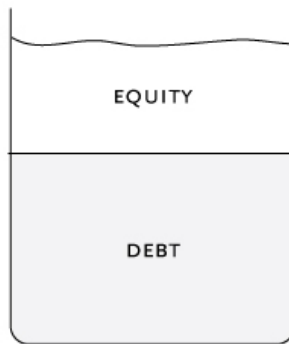
The Right Level of Leverage

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.

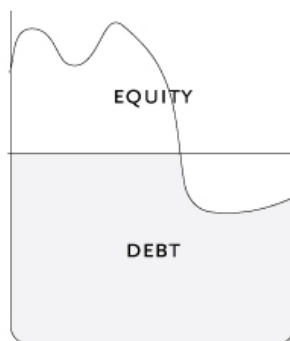
The drawings below show the value of companies of different types. Due to the variability of their earnings, the values fluctuate differently over time.



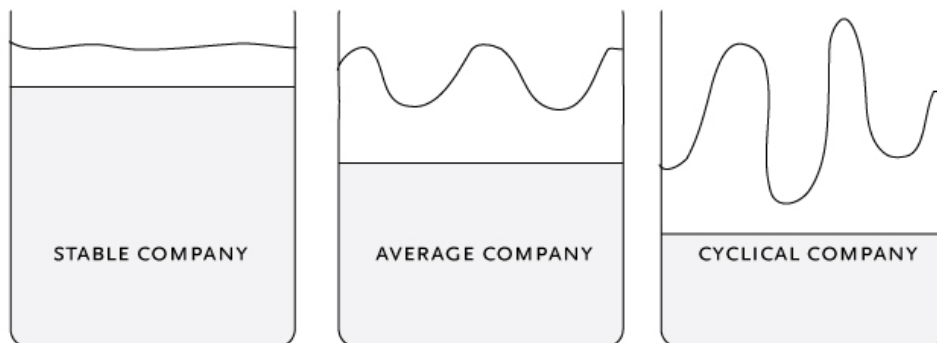
Here's a financial structure, except with the equity above the debt, not below as it would be on a balance sheet:



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.**

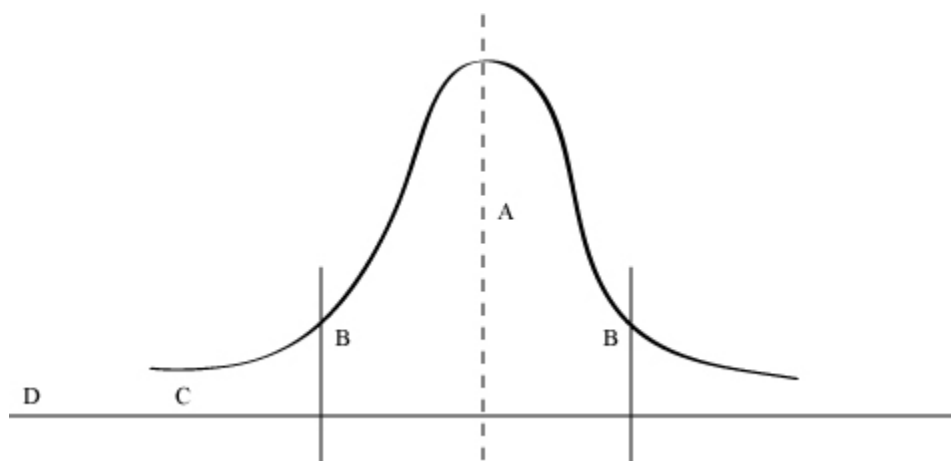
Consider these tales from the front lines:

- 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

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Long View

Many of my memos over the last year and a half have touched on the developments in 2003-07 that brought on the current financial crisis. By now, everyone understands the role of innovation, risk tolerance and leverage in the boom that led to the bust, so I think it's now time to look back considerably further.

The Importance of Cycles

In my opinion, there are two key concepts that investors must master: value and cycles. For each asset you're considering, you must have a strongly held view of its intrinsic value. When its price is below that value, it's generally a buy. When its price is higher, it's a sell. In a nutshell, that's value investing.

But values aren't fixed; they move in response to changes in the economic environment. Thus, cyclical considerations influence an asset's current value. Value depends on earnings, for example, and earnings are shaped by the economic cycle and the price being charged for liquidity.

Further, security prices are greatly affected by investor behavior; thus we can be aided in investing safely by understanding where we stand in terms of the market cycle. What's going on in terms of investor psychology, and how does it tell us to act in the short run? We want to buy when prices seem attractive. But if investors are giddy and optimism is rampant, we have to consider whether a better buying opportunity mightn't come along later.

The Lessons – and Limits – of Experience

I feel good about having been aware of where we stood in terms of the market cycle and investor behavior over the last four or five years. There were memos that talked about low prospective returns and meager risk premiums ("Risk and Return Today," October 2004), repetition of past mistakes ("There They Go Again," May 2005), investor inattention to warning signs ("Hindsight First, Please," October 2005), and the rising willingness to accept lower returns and less safety ("The Race to the Bottom," February 2007). Importantly, these views were factored into Oaktree's actions, enabling us to make some good decisions on behalf of our clients.

I recite these successes not for the purpose of self-congratulation, but to point out that while I was highly aware of the short-term cycle, I – like almost everyone else, it seems – failed to fully appreciate the big-picture peril implied by the level to which the cycle had risen. In short, I thought 2003-07 was like the other cycles I’ve lived through, just more so. I missed the fact that it was different not only in degree, but also in kind.

This episode is different because over the preceding decades, the accretion of progressively higher highs and higher lows – in a large number of phenomena – brought us to a macro-high that hadn’t been witnessed for many years and held great danger . . . as we’re seeing.

Forty years have passed since I first served as a summer trainee in First National City Bank’s Investment Research Department. My experience in seeing investors punished in 1969-70, 1973-74, 1977, 1981, 1987, 1990, 1994 and 2000-02 is what enabled me to detect the excesses of 2003-07. But since I didn’t live through the Great Depression or work through the full run-up to the painful 1970s, I didn’t have the perspective needed to understand where those relatively short cycles of boom/bust/recovery were taking us.

Long-Term Trends

Looking back over my career, it’s clear that the securities markets have been riding a number of salutary secular trends (“secular,” as in “of or relating to a long term of indefinite duration” per *Webster’s New Collegiate Dictionary*). Some of these actually began at the end of World War II and ran through 2007, for a total of more than six decades.

Macro Environment – The period following World War II was one of American dominance and prosperity. The U.S. benefited from the “baby boom,” the fact that our shores hadn’t been reached by the war, and the effective transition of our factories and labor force to peacetime use. We were aided by a modern infrastructure, strong education and healthcare systems, and gains in technology.

Corporate Growth – The last sixty years have seen strong growth in corporations and their profits. Especially in the early part of this period, the U.S. developed superior products, produced them very efficiently and found ready markets in the rest of the world. Gains in automation, information technology, management practices and productivity all contributed. Growth in sales was supported by strong consumer demand.

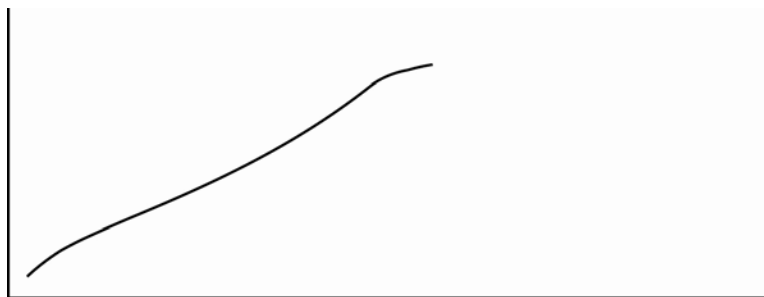
The Borrowing Mentality – As further discussed below, advances in financing – and greater acceptance of the use of debt – allowed companies to augment their growth rates and returns on capital and allowed consumers to increase consumption. In fact, over the last several decades, economic units of all sorts in the U.S. increased their use of debt. Consumers, businesses, governments and investors all wanted to borrow more, and the financial services industry developed products to accommodate them. Spending and

investment was facilitated through the extension of credit at all levels, contributing to economic expansion but also sowing the seeds for the current situation.

Popularization of Investing – Back in 1968, working in investment management was no different from entering banking or insurance. Investing wasn't the high-profile area it's been the last two decades. "Famous investor" was an oxymoron; none were household names, like Warren Buffett, George Soros and Peter Lynch would become. Investment firms weren't the B-school employer of choice, and investment managers didn't dominate magazine covers and the top income brackets. But over the last forty years, increased attention was paid to equities, mutual funds, hedge funds and alternative niche markets. Even homes came to be viewed as investment vehicles.

Investor Psychology – Attitudes morphed over time. Instead of a generation scarred by the Great Depression, people became increasingly confident, optimistic and venturesome. Experience convinced prospective investors that stocks could be counted on for high returns. In the last few decades, there've been times when people concluded the business cycle had been tamed. During Alan Greenspan's reign, people came to believe inordinately in his ability to keep the economy growing steadily. And most recently, people swallowed the canard that innovation, financial engineering and risk modeling could take the uncertainty out of investing.

The developments enumerated above constituted a strong tailwind behind the economy and the markets over the last several decades, and they produced a long-term secular uptrend.



Short-Term Cycles

Despite the underlying uptrend, there's been no straight line. The economy and markets were punctuated every few years by cyclical bouts of short-term fluctuation. Cycles around the trend line made for frequent ups and downs. Most were relatively small and brief, but in the 1970s, economic stagnation set in, inflation reached 16%, the average stock lost almost half its value in two years, and *Business Week* magazine ran a cover story trumpeting "The Death of Equities." No, my forty years haven't been all wine and roses.



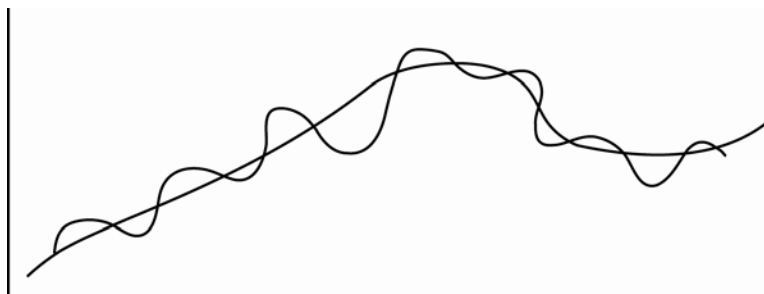
From time to time we saw better economies and worse – slowdown and prosperity, recession and recovery. Markets, too, rose and fell. These fluctuations were attributable to normal economic cycles and to exogenous developments (such as the oil embargo in 1973 and the emerging market crisis in 1998). The S&P 500 had a few down years in the period from 1975 to 1999, but none in which it lost more than 7.5%. On the upside, however, 16 of those 25 years showed returns above 15%, and seven times the annual gain exceeded 30%.

Despite the ups and downs, investors profited overall, investing became a national pursuit, and America's richest man got that way by buying common stocks and whole companies. A serious general uptrend was underway, reaching its zenith in 2007.

The Rest of the Elephant

There's an old story about a group of blind men walking down the road in India who come upon an elephant. Each one touches a different part of the elephant – the trunk, the leg, the tail or the ear – and comes up with a different explanation of what he'd encountered – a tree, a reed, a palm leaf – based on the small part to which he was exposed. **We are those blind men. Even if we have a good understanding of the events we witness, we don't easily gain the overall view needed to put them together. Up to the time we see the whole in action, our knowledge is limited to the parts we've touched.**

Until mid-2007, my experience as a money manager had been limited to part of the long-term story. Perhaps **what looked like an underlying long-term uptrend should have been viewed instead as the positive part of a long-term cycle incorporating downs as well as ups.** Only when you step back from the beast can you gauge its full proportions.



Cycles in Long-Term Trends

The main thing I want to discuss in this memo is my realization that there are cycles in the long-term trend, not just short-term cycles around it, and we've been living through the positive phase of a big one.

Over the last few decades, investors have reacted to the generally positive economic environment by taking actions reflecting increased optimism and trust, as well as reduced caution and conservatism. **In hindsight, we can see nearly uninterrupted growth in behavior that (a) relied on a continuation of the favorable underlying trends and thus (b) can be described as increasingly bullish.**

Looking for just one word, I'd say there was a steady rise in "willingness." Over my forty years in business – but probably carrying on from the end of the World War II – I believe investors grew increasingly willing . . .

- to forget old-fashioned concepts like "saving for a rainy day," fiduciary responsibility and preservation of capital,
- to pursue capital appreciation rather than settle for more modest, steady income,
- to invest on the basis of growth potential rather than existing value,
- to trust that stocks would provide superior performance (see separate section below),
- to drastically reduce the representation of high grade bonds in portfolios,
- to move away from stocks and bonds and toward more exotic investments,
- to believe that diversification into risky assets would increase return more than risk,
- to pursue profit through proprietary investing if you were a bank or investment bank, and for endowments to try to be "more like Yale,"
- to assume that markets would function smoothly even in tough times,
- to trust in markets to solve all problems, induce constructive behavior and efficiently allocate capital, allowing regulation to be reduced,
- to accept that, thanks to market efficiency, asset prices are always "right,"
- to trust in the Fed, Alan Greenspan and the ability to restrain cycles,
- to rely on quants and financial engineers, spreadsheets and risk modeling,
- to feel confident they had a good handle on what the future held,
- to believe in alpha, absolute return, widespread genius among money managers, free lunches, and superior asset classes regardless of how they're priced,
- to revere and trust money managers sporting good returns,
- to share investment gains with money managers, perhaps in ways that motivated them to take increased risk in pursuit of short-term profits,
- to view houses, art, jewelry and collectibles as financial assets,
- to believe that real estate prices couldn't go down,
- to treat investing as a national pastime via TV, magazines and books,
- to "buy the dips,"
- **to accept new paradigms,**
- **to relax diligence standards and forget to question skeptically,**

- to use past statistical averages – sometimes covering brief time periods – to gauge the safety of prospective investments,
- to partake in financial innovation and invest in things too complex or opaque to be understood,
- to believe that risk had been banished, most recently through securitization, tranching and decoupling,
- to forgo liquidity,
- to make increasing use of leverage (see separate section below),
- to finance investment activities with undependable capital: short-term borrowings and deposits, impermanent equity, and future cash receipts,
- to forget to worry and be risk-averse, and thus
- to accept additional risk at shrinking risk premiums.

The “era of increasing willingness” carried many trends to higher highs. The last ten listed above were the prime ingredients giving rise to the current crisis. Together they produced an investment house of cards that was enormously dependent on continued prosperity, bullishness and easy money.

Expansiveness

In addition to “willingness,” one of the most significant trends during the period under discussion has been a massive increase in “expansiveness,” my new label for the desire to increase the ratio of activity to capital. If that sounds unfamiliar, the common term in America is “leverage,” and in England it’s “gearing.”

My last memo was on the subject of leverage and its major role in the crisis we’re all experiencing. Today’s problems are largely a function of the high levels of leverage employed in 2003-07, but those levels were just the apogee of a progression that spanned decades.

Every business, government, non-profit organization or individual has a certain amount of equity capital, net worth or surplus. That capital, in turn, will support a certain level of activity: production and sales, lending, government action, charitable grants or consumption. **But over the last several decades, if you wanted to do more of these things than your capital permitted, you could borrow capital from someone else.**

Over the course of my lifetime, there have been extraordinary changes in the extent of borrowing:

- **Consumers** – When I went off to college 45 years ago, I paid for purchases with checks or cash, and I saved up coins for the payphone. “Travel and entertainment” cards like American Express and Diners Club were available only to those with top credit ratings, and the masses lived without credit cards until Citibank introduced The Everything Card (now MasterCard) around 1967. In the old days, consumers who lived beyond their incomes were often described as being “in debt.” We don’t hear

that term anymore, since people with unpaid credit card balances and consumer loans are the rule, not the exception. As a result, consumer credit outstanding grew 260 times from 1947 to 2008, increasing from 4.2% of gross domestic product to 17.9%. (Federal Reserve data and Economagic)

- **Homeowners** – In the old days, homebuyers, having saved for years, usually put down 20% of the cost of a home and borrowed the rest through a thirty-year fixed-rate mortgage. They made payments until that debt was eliminated, and they held mortgage-burning parties to celebrate the event, which would enable them to retire mortgage-free. Only people who were “in trouble” took out second mortgages, perhaps to meet emergency expenses. All of these concepts went out the window in recent times, when down payments, fixed rates and paid-off mortgages became things of the past, replaced by 100% financing, adjustable rates, teasers and serial refinancings. Second mortgages were relabeled “home equity loans,” little miracles that would let people draw out the inevitable appreciation in their homes, spend it, and end up with the same home and larger payments – perhaps just as interest rates moved up or as the borrowers hoped to be able to retire.
- **Corporations** – “In the beginning,” corporate borrowing was most undemocratic. Prior to the late 1970s, only firms with investment-grade credit ratings of triple-B or better could publicly issue bonds. But that changed with the introduction of high yield bonds, an innovation permitting low-rated issuers to borrow at high interest rates. Before the advent of high yield bonds, companies could be acquired only by companies bigger than themselves. But with high yield bonds, small firms and even wealthy individuals could borrow enough to acquire corporate giants. This created the leveraged buyout industry. In recent years, not only was debt added to capital structures (particularly through buyouts), but equity was subtracted. Buyout companies used borrowed funds to dividend out their owners’ equity and provide quick profits, and non-buyout companies bought back their shares, often using borrowed money. These activities substituted debt for equity in companies’ capital structures, leveraging up their results and reducing their margin for error. In the current credit crisis, this has led to large-scale capital destruction.
- **Financial Institutions** – Over the decades in question, banks and investment banks moved away from working for interest, fees and commissions as lenders, advisers, brokers and agents. Instead, they went increasingly into positioning (buying or selling blocks of stock to accommodate clients when the market wouldn’t take that side of a trade), proprietary trading (making investments for their own accounts, not on behalf of clients), and creating derivatives (sometimes ending up with a holding), all on the basis of increased leverage. “In 1980, bank indebtedness was equivalent to 21 percent of U.S. gross domestic product. In 2007 the figure was 116 percent. . . . It was not unusual for investment banks’ balance sheets to be as much as 20 or 30 times larger than their capital, thanks in large part to a 2004 rule change by the Securities and Exchange Commission that exempted the five largest of those banks from the regulation that had capped their debt-to-capital ratio at 12 to 1.” (*Vanity Fair*, December 2008)

- **Governments** – Similarly, governments at all levels learned increasingly to spend borrowed money in addition to their revenues. Federal, state and local debt ballooned to facilitate both capital projects (reasonably) and deficit spending (less reasonably). The Federal debt grew from \$1 trillion in 1980 to \$11 trillion today. How? In 2003 and 2004, for example, the government spent \$1.42 per \$1 of income taxes. In this way, the U.S. became a debtor nation, dependent on bond buyers – particularly from abroad – to let it spend beyond its means. Likewise, state and local debt grew from \$1.19 trillion in 2000 to \$1.85 trillion in 2005, an average increase of 9.2% per year. In an extreme example of unwise innovation, much of the issuance of muni bonds was made possible because weak issuers could obtain bond insurance; few prospective investors, however, looked into the financial strength of the insurers.
- **Investors in General** – Fifty years ago, the main way investors expanded their activities was through the use of “margin,” borrowing from their brokers to buy stock. Initial margin for new purchases was strictly limited to 100% (e.g., at most you could buy \$2 worth of stock for every \$1 of equity in your account). But Wall Street proved increasingly creative, and in the current decade it came up with products “with the leverage inside.” These made much more than 100% leverage available to investors without any explicit borrowing. Hedge and arbitrage funds, collateralized loan obligations, collateralized debt obligations, leveraged buyout funds, credit default swaps and other derivatives; all of these delivered participation in highly leveraged investments without requiring the end investor to use margin or take out loans. In what approached a joke, the prim limit on margin was maintained even as regulators declined to apply any limits or regulation to these other investment structures, despite their ability to provide almost infinite leverage.
- **Institutional Investors** – Given their tax-exempt status, pension funds and charitable and educational endowments can’t borrow to increase their returns. But they can (and did) make use of some of the strategies listed above. Institutional investors also employed “portable alpha,” overlaying hedge fund investments with index futures to simulate more-than-100%-invested positions, and they overcommitted to private equity partnerships to ensure their capital would be fully deployed.

The use of borrowed money expanded at all levels over the last few decades. This occurred largely without changes in laws or institutions. Instead, the changes were in customs and attitudes, abetted by financial institutions’ innovation of new products.

Of all the investment adages I use, this one remains the most important: “What the wise man does in the beginning, the fool does in the end.” Practices and innovations often move from exotic to mainstream to overdone, especially if they’re initially successful. What early investors did safely, the latecomers tried in 2003-07 with excessive leverage applied to overpriced and often inappropriate assets. As I wrote in “It’s All Good” (July 2007), leverage was the “ketchup” of this period, used to make unattractive underlying investments appear tasty. The results have been disastrous.

Here's another way to put it, from *The Wall Street Journal* of November 24,

When it comes to booms gone bust, "over-investment and over-speculation are often important; but they would have far less serious results were they not conducted with borrowed money."

That statement wasn't made in reference to current events; that was Irving Fisher writing 76 years ago ("The Debt-Inflation Theory of Great Depressions," *Econometrica*, March 1933). Borrowed money lets economic units expand the scale of their activity. But it doesn't add value or make things better; it just makes gains bigger and losses more painful. There's an old saying in Las Vegas: "The more you bet, the more you win when you win." But they always forget to add "... and the more you lose when you lose."

In one of those beautiful phrasings that demonstrate his mastery of language, Jim Grant of *Grant's Interest Rate Observer* has described liquidity and leverage as "**money of the mind.**" By this he means they're intangible and ephemeral, not dependable like assets or equity capital. Someone may lend you money one day but refuse to renew your loan when it comes due. Thus, **leverage is purely a function of the lender's mood.** The free-and-easy lending of 2003-07 has turned into an extreme credit crunch, and the unavailability of credit is both the root and the hallmark of today's biggest problems. **Those who expand the scope of their operations on the basis of borrowed money should always consider the possibility that lenders will change their mind.**

Use of Debt in the Corporate World

Note three things regarding debt. **First, all businesses borrow.** Debt is used broadly to finance things ranging from inventories to capital investment. If companies had to wait to get paid by buyers before ordering new goods to sell, business would go much slower. And if all their capital had to be equity, capital would be much more costly and companies would be much smaller. Borrowing makes the business world go 'round.

Second, debt is rarely repaid. Businesses rarely reduce their total indebtedness. Rather than being paid off, debt is simply rolled over. That makes the solvency of the borrowers contingent on the continuous availability of credit.

Third, given that the yield curve normally slopes upward, short-term borrowing is almost always the least expensive. That's what led First National City Bank to invent commercial paper in the 1960s, enabling companies to borrow at short-term rates through short-dated paper that would be renewed every month or so. The upward slope of the yield curve encourages people to borrow short even when investing long, resulting in economic maximization when they're able to roll over their debts but disaster when they aren't. (The recent failure of "auction-rate preferreds" was a good example of the folly of trying to game the yield curve by financing for the long term at short-term rates.)

Here's what follows from the above:

- Most companies have debt, not just those that have made acquisitions or built plants. Companies borrow in the normal course of business.
- Many companies have heavy short-term borrowings and thus the need to deal with substantial maturities in the period immediately ahead.
- With the capital markets closed, not only will growth be difficult to finance, but significant defaults may also arise due to a widespread inability to refinance.

While I always hesitate to predict the future, I think there's a good chance the next year or so will be characterized by significant difficulty repaying and refinancing borrowings. It's worth noting in that context that "In November, there wasn't one sub-investment grade corporate bond issued, according to Reuters – the first such hiatus since March 1991." (*breakingviews.com*, December 3)

Attitudes Regarding Equities

One of the biggest changes in the past century – fully visible only to those who already were adults several decades ago or who've read about it – took place in terms of attitudes towards equities (or what we used to call common stocks).

Up until the middle of the last century, stocks were considered highly speculative, and bonds were the bedrock of most investment portfolios. Interestingly in that connection, it was reported recently that the S&P 500 now out-yields the 10-year Treasury for the first time in 50 years. **Until the 1950s, equities always provided higher current yields . . . for the simple reason that they had to. People invested primarily for yield, and riskier securities – stocks – would attract buyers only if they promised higher yields than bonds.**

This changed in the second half of the 20th century:

- Common stock investing was popularized; I believe Charlie Merrill of Merrill Lynch deserves a lot of the credit for this.
- Prior to some pioneering computer work at the University of Chicago in the 1960s, the historic returns on stocks had never been scientifically quantified. Then the Center for Research in Security Prices came up with the 9.2% compound annual return that fired many investors' appetites.
- The concept of growth-stock investing was popularized in the 1960s; I remember reading a broker's brochure about companies with exciting earnings growth. This led to the "nifty-fifty" investing craze, in which investors (and especially bank trust departments) bought the stocks of fast-growing companies regardless of valuation.

The equity boom burst in the 1970s. We experienced an oil embargo, a very serious recession, inflation rates ranging up to 16%, a 45% decline in the S&P 500 in 1973-74,

and considerably larger losses in nifty-fifty stocks. The stock market stayed in the doldrums for years, brokers drove cabs (literally), and *Business Week* ended a dismal decade with its downbeat cover story on stocks.

In fact, the economy, markets and attitudes turned so negative for so long in the 1970s that rather than a ***downward cycle around the long-term upward trend***, one might say the decade marked a ***downturn in the long-term trend*** (clearly there's no standard for these things). Regardless of what you call it, the decline was so big that it took almost eleven years for the Dow Jones Industrials to get back to the high it reached at the beginning of 1973.

But in 1982, stocks returned to what would be a 25-year bull market, and there arose an even greater cult of equities. Wharton Professor Jeremy Siegel wrote *Stocks for the Long Run*, showing there'd never been a long period in which stocks hadn't outperformed cash, bonds and inflation. Everyone concluded stocks were the asset class of choice and the ideal investment. "65/35" was the usual stock/bond balance in institutional portfolios, but eventually stocks became more heavily weighted, as strong performance in the 1980s and '90s further fired peoples' ardor and as stocks' long-term return was upgraded to 11%. **Few investors recognized that increasing past returns bode poorly – not well – for subsequent returns, or that common stock returns couldn't forever outpace the rate of growth in corporate profits.** In 1999, James Glassman chimed in with his book *Dow 36,000*, asserting that because stocks were such solid investments, equity risk premiums were higher than they should have been, meaning their prices were too low. That pretty much marked the long-cycle top.

When the "tech-media-telecom" bubble burst in 2000, stocks went into their first three-year decline in almost 70 years. The broad indices stabilized after 2002 and returned to their 1999 highs in 2007 but, wanting more than equities' unlevered return, investors shifted their focus to private equity and to equity hedge funds. All of this occurred just in time for the onset of the credit crisis. Last year's 38.5% decline in the S&P 500 was the biggest since 1931, zeroing out more than a decade of gains.

I wonder whether and to what extent equities will be returned to the pedestal of popularity. *The Wall Street Journal* put it aptly on December 22:

One of the hallmarks of the long market downturns in the 1930s and the 1970s has returned: Rank-and-file investors are losing faith in stocks.

In the grinding bear markets of the past, huge stock losses left individual investors feeling burned. Failures of once-trusted firms and institutions further sapped their confidence. Many disenchanted investors stayed away from the stock market, holding back gains for a decade or more.

Today's investors, too, are surveying a stock-market collapse and a wave of Wall Street failures and scandals. Many have headed for the exits:

Investors pulled a record \$72 billion from stock funds overall in October alone

If history is any guide, they may not return quickly.

I want to make a heretical assertion: that equities aren't the greatest thing since sliced bread, but rather an asset class that can do well or poorly depending on how it's priced. Investors fell into a trap at the 1999 peak because they were seduced by stocks' long-term average return in addition to their recent gains. Rather than ask "What's been the historic return on stocks?" they should have asked "What's been the historic return on stocks if you bought them when the average p/e ratio was 29 (which it was at the time)?" Once again, investors came to believe in the magic asset class and forgot the importance of reasonable valuation.

The truth is, rather than being superior, equities are an inferior asset class . . . structurally, that is. Unlike debt, they don't promise annual interest or repayment at maturity, and they don't carry a senior claim against the company's assets in case of trouble. All they offer is an uncapped participation in profits. Debt promises a stream of contractual payments, and common stocks provide the residual that remains after those payments have been made. **Thus equities' higher historic average and potential future returns should be viewed as nothing more than compensation for their inferior status and greater volatility. They're not magic, just securities that can perform well when they're priced right for the coming profits. If sluggish growth lies ahead for the economy in the next few years, it's no given that common stocks will outperform corporate bonds.**

Go Around, Come Around

Mark Twain is alleged to have said "History doesn't repeat itself, but it does rhyme." Mistakes follow long-standing patterns, but applied in new ways. Thus it's worth noting a few of the many ways in which events of the pre-crisis years are reminiscent of the Roaring Twenties that preceded the Great Crash.

- In the 1920s, stock manipulators banded together to force down the price of stocks through non-stop short selling. The damage caused by these "bear raids" led to implementation of the "uptick rule," under which shares could be shorted only at prices higher than the last. This rule made it hard for short sellers to drive down prices, and it remained in effect right up until July 2007. Its elimination enabled bears to once again drive down the stocks of weakened financial institutions, an emblematic event in 2008.
- The combination of banking and investment banking under the same roof received a good part of the blame for the Great Crash (see one of my favorite books, *Wall Street Under Oath* by Ferdinand Pecora, 1939). This led to passage of the Glass-Steagall Act mandating separation of the two. It was revoked in 1999, and when they were

recombined, the battle between bankers' caution and investment bankers' risk tolerance was won by the latter, putting institutions that were "too big to fail" in jeopardy. This played no small part in the current crisis.

- Also in the '20s, "bucket shops" provided easy access to investment risk. They would take "side bets" on the direction of stocks from small customers without actually sending orders to the exchange. Instead, they'd throw order slips "in the bucket" and hold the risk themselves. *Voilà*: investment exposure without a stock market transaction. The other day, Charlie Munger reminded me of the similarity of bucket shops to today's derivative contracts, which likewise permit bets on investments without any actual transactions taking place in the underlying securities. Massively levered derivatives played a big part in this decade's build-up of risk.

Developments like these don't happen randomly. They're the logical next step after optimism and ardor have increased, caution has subsided, and the desire for protective regulation has abated. The relaxation of worry eventually leads to environmental changes that permit excesses.

The Culmination

When the long-term pendulum is at its negative extreme, it can be counted on to turn for the better at some point, passing the midpoint and continuing toward the positive part of its arc. Eventually the pendulum will reach an apex so high that it'll be incapable of staying there. Then it will swing back, whether under its own weight or because of exogenous forces, or both. **In the course of moving from merely heated to torrid, however, I believe it can be counted on to bring out behavior which is manic and dangerous.**

The current long-term cycle may have begun in the post-World War II recovery. It benefited from the positive factors discussed on pages 2 and 3 and resulted in great capital creation for consumers, homebuyers, businesses, non-profits and investors. But it continued on from "healthy" to "excessive," resulting in the events of the last eighteen months, many of which can be summed up under the heading of capital destruction.

The greatest single example may be the case of Bernard Madoff, in which a trusted, high-performing investment manager allegedly fabricated his record, deceived friends and strangers alike, and lost or stole \$50 billion. An increase in fraud can be viewed as a normal component – in fact, perhaps emblematic – of frothy, cycle-driven markets. Who hears of embezzlement during bearish times? A few lines from the *Financial Times* of December 20 indicate the cyclical aspects of the Madoff affair:

The size of the alleged Bernard Madoff scam . . . is astounding, yet unsurprising. History tells us that bubbles spawn swindles. After the biggest credit bubble of all time, we now may have the biggest swindle of all time. . . . The historian Charles Kindleberger believed that "swindling

is demand-determined, following Keynes's law that demand determines its own supply. . . .”

Mr. Madoff's story was dull . . . but compelling in a credit bubble where yields were everywhere falling. . . .

When a wave of redemptions hit the Madoff funds, the Ponzi scheme . . . became unworkable. . . . Reputations inflated in the bubble [of the 1920s] promptly evaporated in the 1929 crash, which exposed a plethora of swindles. Redemptions of the hedge funds business are having the same effect today.

Having appreciated in the up cycle, mainstream securities offered only meager returns going forward, causing investors to turn elsewhere. Madoff's steady 10-11% returns wouldn't have blown off anyone's socks in the 1990s, but they were enticing in the 2000s. **Add in the optimism, credulity and loosey-goosey attitudes that always accompany the top of a cycle, and the atmosphere was right for what John Kenneth Galbraith called a good “bezzle.”** But when things retreated from the lofty level that couldn't be maintained, investors put in for redemption and the falsehoods came to light.

The Madoff scam was cut from the same up-cycle-gone-wild cloth as the elimination of the uptick rule. Scams; unsupportable mortgages on overpriced homes; over-leveraged hedge funds, debt pools and buyouts; insurers with inadequate capital; managers incapable of doing what they said they could . . . as Warren Buffett says, they're all exposed when the tide goes out. What are the results to date? The outing of the biggest fraud in history; \$1 trillion of write-offs by the banks thus far; \$7.8 trillion committed to “recovery activities” by the U.S. alone; the biggest decline in the Dow Jones Industrials in 77 years; more than a decade of equity appreciation lost; the disappearance of every major U.S. non-bank investment bank; and a cry for more and better regulation. Now that the bursting of the credit bubble has affected the general economy, we're seeing declining consumer incomes, confidence and spending; plummeting home sales, home prices and housing starts; and the highest unemployment rate in many years. **All of this is part and parcel of the long-term cycle.**

Trends Just Ahead

Unlike the “era of increasing willingness,” many things will face increased difficulty in the months and years just ahead. It'll be tougher times for anything dependent on:

- **bullishness, willingness and expansiveness,**
- **increasing economic activity and consumer spending,**
- **the ability to incur, service, repay or refinance debt,**
- **asset sales and the ability to delever, and**
- **strong asset values and investment returns.**

Clearly, it was in the financial world, not the “real world,” that the great excesses of bullishness, willingness and expansiveness developed, planting the seeds for the current crisis. But financial-sector attitudes and innovations allowed excesses in all the things listed above to be visited upon the real world, where we’re now experiencing difficulty in them. It’s no coincidence that history-making excesses in the financial sector – and the correction thereof – led to history-making weakness in the real economy.

It may be a good while before the elements listed are fully restored and the long-term trend roars upward again. The government is doing everything it can to reinstate them, but there’s no roadmap for success. We all have to wait with fingers crossed. However, in the coming period, while we’ll be hoping for the short-term cycle to recover, it’s quite likely that the long-term trends listed on pages 2 and 3 will be less salutary than they were in decades leading up to the current crisis.

When will cyclical recovery arrive? For this, too, there’s no roadmap. Most economists rely for their predictions on models that extrapolate relationships between investment, production, employment and consumption, for example, but they omit psychological considerations such as bullishness, willingness and expansiveness. On January 3, a *New York Times* article reported that a survey of economists had found consensus that recovery would commence in the second half of 2009. But it added that the economists:

. . . base their forecasts on computer models that tend to see the American economy as basically sound, even in the worst of times. That makes these forecasters generally a more optimistic lot . . . their computer models do not easily account for emotional factors like the shock from the credit crisis and falling housing prices that have so hindered borrowing and spending.

Those models also take as a given that the natural state of a market economy like America’s is a high level of economic activity, and that it will rebound almost reflexively to that high level from a recession.

But that assumes that banks and other lenders are not holding back on loans, as they are today, depriving the nation of the credit necessary for a vigorous economy.

These forecasters might assert that their models have worked on average. But I’d guess the period during which they worked didn’t include sluggishness in long-term trends of the nature I’m discussing here. **Recognizing times when historic data shouldn’t be extrapolated is an important part of dealing prudently with the future.**

Importantly in this context, I want to point out that the recent decades shouldn’t be considered a norm to which we’re sure to return. Instead, they were the best of times. Most years saw good returns; most investments paid off (often the riskier the better); and most investors made a lot of money. The financial services industry

prospered, and its people made a lot of money and had inordinate fun doing so. From 1987 to 2007, “securities, commodity contracts, and investments” grew twice as fast as total gross output. And according to *The New York Times* of December 19, in 2007, “. . . the average salary of employees [in that category] was more than four times the average salary in the rest of the economy.”

In other words, it was high tide. All financial boats were lifted, obscuring who was swimming without a bathing suit. In times like those, you can make money through skill or just aggressiveness, and it’s hard to tell which is which.

In my view, superior investors are the ones who make more money in the good times than they give back in the bad. The ebb tide in the next few years will show us which they were. Managers who perform relatively well for their clients in this period will be recognized and rewarded. The rest shouldn’t be able to amass funds or command fees as effortlessly as they did in the past. Of course, we hope Oaktree will be among the former. We’ll all know in a few years. **In the new, chastened environment, I don’t think anyone will jump to conclusions as readily as they did in the past.**

The other day, I was speaking with a reporter who summed up what I had said: “So skepticism will be greater; investors will be more risk-averse; fund raising will be harder; and fees will receive more scrutiny. That’ll be worse for business, right?” For the short run and for managers who failed their clients, it likely will. **But in the long run, it’ll make for a much healthier environment for all of us.**

The Importance of the Long View

As usual, some of the most important lessons concern the need to (a) study and remember the events of the past and (b) be conscious of the cyclical nature of things. Up close, the blind man may mistake the elephant’s leg for a tree – and the shortsighted investor may think an uptrend (or a downtrend) will go on forever. But if we step back and view the long sweep of history, we should be able to bear in mind that the long-term cycle repeats and understand where we stand in it. The failure to do so can be most painful. John Kenneth Galbraith provided a reminder in *A Short History of Financial Euphoria*:

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.

Jim Grant did a good job of putting a cyclical movement into perspective in the January 31, 2003 issue of *Grant's Interest Rate Observer*:

Wall Street today is in one of its recurrent sinking spells. Many call it a crisis of confidence, by which they mean under-confidence. Less attention is given to the preceding crisis of overconfidence. Material progress is cumulative, but markets are cyclical. First, investors trust too much, then they doubt too much. They believe that no price is too high to pay for a stock or a bond, then they doubt that any price is too low. So credulity is followed by cynicism, unreasonably high prices by ridiculously low ones.

Central banks will try to stabilize economies, and company managers will strive for smooth earnings growth. But as long as human beings determine security prices, market cycles will be the rule, not the exception. The extremes of greed, fear and worry over missing out will never be banished.

At times investors will be too risk-tolerant, and at others they'll be too risk-averse. They'll forget to inquire skeptically after things have gone well for a while, just as they'll ask too many questions and hesitate too much when recent events have decimated securities prices (and investors' psyches). **As little as two years ago, investors rushed headlong into things, fearing that if they didn't, they'd miss out on big gains. Now they're keeping their money in their wallets, saying "I don't care if I ever make a penny in the market again, I just don't want to lose any more." This change in attitudes – throughout the financial system – is responsible for a lot of today's deep freeze.**

Over the last several decades, our economy and markets benefited from positive underlying trends and investors were well rewarded for bearing risk. As a result, there was rising bullishness, willingness and expansiveness. When these trends reached unsustainable excesses, they were corrected with a vengeance. **I'm now of the opinion that not only will short-term economic cycles of boom and bust repeat regularly, but also that favorable long-term trends are bound to see a recurrence of this sort of occasional massive pullback . . . at that moment when the passage of time has erased all memory of past corrections and taken investor behavior (and thus asset prices) to unsustainable highs.**

Buoyant, decades-long up-trends and their explosive endings are the inevitable results of the tendency of human nature to go to extremes. Hopefully the current bursting of the long-term bubble will end within the next few years, and hopefully the next iteration is another 30, 50 or 70 years away. This one's providing enough excitement for a lifetime.

January 9, 2009

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Memo to: Oaktree Clients

From: Howard Marks

Re: Will It Work?

The other day, my son Andrew – college senior and credit-analyst-to-be – asked whether I think Treasury Secretary Geithner is doing the right things. As has happened before, his question elicited a fatherly response that grew into this memo.

When you want a bridge built, you hire a civil engineer whose “calcs” will determine exactly how much concrete and steel should be used. Then it’ll be sure to hold the weight of the cars you expect to cross it. And if you have to perform a task in carpentry, you can employ specialized tools developed and tested expressly for the job: esoteric things like miter boxes, routers and extractors.

One of the most important things to bear in mind today is that **economics isn’t an exact science**. It may not even be much of a science at all, in the sense that in science, controlled experiments can be conducted, past results can be replicated with confidence, and cause-and-effect relationships can be depended on to hold. It’s not for nothing that economics is called “the dismal science.”

Solutions in economics aren’t nearly as dependable as engineers’ calculations, and there may not be a tool that’s just right for fixing an economy. Of course, the toolbox offers lots of possibilities, including interest rate reductions; quantitative easing; tax cuts, rebates and credits; stimulus checks; infrastructure spending; capital injections; loans, rescues and takeovers; regulatory forbearances and on and on. **But no one should think there’s a “golden tool,” such that solving the problem is just a matter of figuring out which one it is and applying it.** Anyone who holds the problem solvers to that standard is being unfair and unrealistic. There are a number of reasons why, including these:

- Every situation is different, and none is exactly like any that has come before. That means fixed recipes can’t work. Certainly this one has never been seen before.
- Most policy actions aren’t all good or all bad. They merely represent imperfect compromises as to ideology, goals, problem solving and resource allocation.
- Economic problems are multi-faceted, meaning the solution for one aspect might not work on – and in fact might exacerbate – another aspect.
- Economies are dynamic, and the problems are moving targets. The environment changes constantly, rather than sitting still and waiting for a solution to work.
- **The main ingredient in economics is psychology, and the workings of psychology clearly can’t be fully known, controlled or fixed.**

Here's how Thomas Friedman put it in *The New York Times* of January 31:

Everyone is looking for the guy – the guy who can tell you exactly what ails the world's financial system, exactly how we get out of this mess and exactly what you should be doing to protect your savings. . . . But here's what's really scary: the guy isn't here. He's left the building. . . .

There is no magic bullet for this economic crisis, no magic bailout package, no magic stimulus. We have woven such a tangled financial mess with subprime mortgages wrapped in complex bonds and derivatives, pumped up with leverage, and then globalized to the far corners of the earth that, much as we want to think this will soon be over, that is highly unlikely.

The "I know" school (which first appeared in a memo in 2001) is still making predictions. Statistical comparisons are being made to past recessions and solutions extrapolated from those experiences. Thus it's the consensus of this school that the recovery will start during the first quarter of 2010. I also see people projecting a stock market rebound based on the average time between past declines and the recoveries therefrom.

I think it's a mistake to hold confident opinions about the events of today. Instead, I think this is a great time to reaffirm faith in the "I don't know" school, of which I'm a card-carrying member. No one should feel certain they know what's going to unfold, or when. **The only things we have to fall back on at this juncture are intrinsic value, company survival and our own staying power as investors.** Of course, even these things mean we have to make judgments about what the future is likely to look like. That requirement, in turn, means nothing can be approached with complete safety or certainty. Nevertheless, we can take action if we think those three elements will be present under most circumstances. That's the right mindset for today.

Harder Than Sudoku

The impossibility of reaching into the economic toolbox for that one perfect tool is easily illustrated with a list of some of the challenges present today. For a learning exercise, skip today's Sudoku or crossword puzzle and take a crack at resolving these dilemmas:

- Consumer confidence and spending are weak. We want to stimulate, but we don't want to replace weakness with hyperinflation.
- We're willing to drop fiscal discipline in favor of stimulus through deficit spending, but we don't want to scare away offshore investors from the Treasury securities we'll issue to fund our deficits.
- We're willing to distribute stimulus checks, but we seem unable to make frightened individuals spend the money rather than save it.
- In fact, we know consumers got into trouble by spending more than they earned, and

now they should build some savings. But whereas in the recent past consumer spending grew faster than incomes, a rising savings rate means spending would grow slower than incomes, just at a time when incomes are falling and spending is needed.

- Likewise, with tax revenues down, states and cities have to balance their budgets. One way to do so is to raise income tax and sales tax rates, but this will further depress local economies and increase the burden on their beleaguered citizens.
- We want to recapitalize the banks, but we don't want to reward past mistakes.
- We're thinking about buying the banks' "toxic" assets. But if we pay above-market prices, that's a subsidy to the reckless (see above), and if we pay market or below-market prices, that will further erode bank capital through write-downs.
- We know suspending mark-to-market accounting would end write-downs, but doing so might also reduce confidence in balance sheets and postpone the day of reckoning needed for our financial institutions to reach bottom and recover.
- We want the banks to lend, but we can't – and shouldn't – make them extend loans to non-creditworthy borrowers.
- We want to reduce the incidence of home foreclosure, but we don't want to reward people who speculated by buying multiple homes or lied on mortgage applications. And we'd rather not treat people who bought more house than they could afford better than those who acted prudently.
- We want to make mortgage relief available to those who are unable to service their mortgages, but we don't want to give people incentives to stop making payments.
- We're considering letting bankruptcy judges reset mortgage contracts, but we don't want to tell lenders that loan contracts are no longer sacrosanct, which certainly would deter them from making new loans.
- We don't want the depressant impact of auto companies going bankrupt and suppliers and dealers following suit. But we also don't want to pump money into the industry unless we're confident it can produce good cars at competitive prices.
- We want to see the auto industry "rationalized," but that means seeing people lose their jobs or have their paychecks reduced, which would spread pain, put stress on benefit funds, and cut into GDP.
- We want taxpayer-supported automakers to use American steel, but (assuming it's more expensive than imported steel) that will either (a) raise car prices, making cars more expensive for hard-pressed buyers and making the Big 3 less competitive, or (b) require the companies to eat the difference, making it harder for them to achieve profitability.
- We want to curb speculation in derivatives, but we don't want to make it harder for businesses, farmers, insurers and investors to legitimately hedge risk.
- In fact, we want to prevent excesses on the part of business, but most people don't think it's a good idea to nationalize companies or have the government tell them how to operate.

It's abundantly clear from this list – and it's only a partial list – that solving the current problem will require compromises and a combination of disparate elements. Some will work, while others will fail and have to be replaced. And some will work with regard to one facet of the problem but aggravate another. Lastly, no one should think that even a wise combination will produce quick results.

Regulating Excess Compensation

Some of the excesses the government wants to stop are in the area of compensation at rescued banks. Excessive compensation seems to have a lot in common with hard-core pornography: As Potter Stewart, Associate Justice of the United States Supreme Court, wrote about the latter, it's hard to define but "I know it when I see it."

It's easy to react adversely when an institution that lost billions and needed a taxpayer bailout is seen paying millions or billions in executive bonuses. But how do we define excessive compensation, and what should be done about it? **More importantly, how do we make sure the cure won't be worse than the disease?**

On February 14, *The Wall Street Journal* reported that,

The giant stimulus package that cleared Congress Friday includes a last-minute addition that restricts bonuses for top earners at firms receiving federal cash . . . The most stringent pay restriction bars any company receiving funds from paying top earners bonuses equal to more than one-third of their total annual compensation.

Some limitation on compensation at taxpayer-supported institutions seems reasonable and unavoidable. But is this provision a good thing? Here are some of the problems:

- It doesn't limit compensation, just bonuses.
- **Bonuses – especially if tied to achievements – should be preferable to high salaries from the point of view of shareholders and taxpayers.** In fact, it was just a few years ago that federal legislation created a preference for incentive compensation tied to benchmarks.
- An executive with a \$1 million salary is in compliance with this restriction if he receives a bonus of \$500,000. But one who's paid \$250,000 is in violation if he receives a bonus of \$200,000. Should the taxpayer prefer the former to the latter?
- Past challenges, like mobilizing industry for World War II, were met by recruiting "dollar-a-year" leaders. **One hope here might be that able businesspeople will come forward to work for nothing but a big success fee.** Citigroup CEO Vikram Pandit is receiving a salary of \$1. Should we really limit his bonus to 50 cents?
- **The new law will limit bonuses at taxpayer-assisted banks, not all banks. Will that doom the rescued banks to second-rate management? And thus second-rate profitability? Is that desirable?**
- **Bank managements and boards may want to avoid this limitation, and to do that they may turn down or rush to repay federal money. Doing so may reduce the banks' capital, weakening them and inhibiting their ability to lend.**
- Even the biggest losers among the banks had some profitable units and excellent managers. Do we want the weak institutions to lose these to their stronger peers because they can't pay competitively?
- **Does the fact that some bank managers made grave mistakes in recent years mean no bank executives can be deserving of high compensation? Does the**

government really want to stigmatize the field of banking and chase able executives from it to industries where compensation is unregulated?

- The last time I saw legislation with near-unanimous appeal on a corporate-behavior issue was in 2002, after the Enron scandal. American business is still suffering from some of Sarbanes-Oxley's less-well-conceived provisions.

Observers are disappointed when recovery plans aren't announced quickly or in detail. Yet here's a provision that was inserted quickly and in detail, and it doesn't do a lot to advance the ball. Bottom line: a quick fix will prove hard to come by.

Who's Right?

My mother used to tell a story about the *shtetls* – villages – in the old country where disagreements were settled by the rabbi. In one, an argument was raging with no possible grounds for compromise. The villagers brought the two parties to the rabbi. "Tell your side," the rabbi said to one fellow, and he did. "**You're right,**" the rabbi declared.

One of the bystanders piped up: "You can't tell him he's right, rabbi; you haven't heard the other side of the story." So the rabbi told the other party to tell his side, and he did. His story was the polar opposite of the other party's. "**You're right,**" said the rabbi.

"Hold on, rabbi," a villager said, "the first guy told his story and you said he was right. Then the other guy told his story – different in every regard – and you said he was right. They both can't be right." "**And you're right,**" said the rabbi.

The current disagreement over bank nationalization shows that (a) there can be valid arguments on both sides of an issue and (b) it can be hard to figure out who's right. Here are a few of the pros and cons as advanced by *The Wall Street Journal* on February 24:

What are the pluses to nationalizing firms?

Some banks are bleeding slowly toward insolvency. Nationalizing them promptly would allow the government to wipe out the most toxic assets, reorganize what is left and sell the remains to private investors. On a broader front, nationalization could help heal the banking system and encourage the remaining firms to boost lending.

What are the minuses?

Investors in the nationalized bank would likely be wiped out. And nationalizing even one or two banks could create a chain reaction of failing confidence. . . .

Nationalization would also be expensive and complicated, taxing a bureaucracy that isn't set up to operate mega-firms. And while the goal of

nationalization may be to return companies to private hands, the temptation to run them for political purposes would be immense.

Obviously, there are arguments on both sides.

One Proposal

The other night, I had dinner with my friend Richard Ressler, principal and founder of CIM Group. He has an idea as to how things can be fixed (as usual), and it's a pretty good one. I'll summarize below his thoughts on the banking industry:

- There are banking institutions which, because of their magnitude and significance, should be supported through deposit insurance, government guarantees and rescues.
- These banks should engage only in the prosaic acts of accepting deposits and making loans. They should not take on ultra-high leverage or make exotic investments. And they shouldn't do business through unregulated, off-balance-sheet subsidiaries.
- Institutions that wish to do things that are off-limits to these banks should do so, but without the benefit of government protection. If they want to take on 30-times leverage and pursue proprietary profits, they should bear the consequences themselves.
- Thus banking and risky investing should be separated.

In *The New York Times* of February 2, Professor Paul Krugman of Princeton argued that we have to avoid "lemon socialism: taxpayers bear the cost if things go wrong, but stockholders and executives get the benefits if things go right." One way to prevent this, as Richard suggests, is to make sure government support and high-octane risk taking don't take place in the same firms.

I've been told it isn't his, but a saying widely attributed to Mark Twain seems to be on the mark: "History doesn't repeat itself, but it does rhyme." There's no need to invent the mechanism through which to accomplish the above; we can look to history and gain inspiration from the Glass-Steagall Act.

After the Great Crash, congressional committees investigated its causes, some of which remind one of today's. The result was this 1933 law, which mandated that banking be separated from investment banking and investment services. It's far from irrelevant to the current situation that Glass-Steagall's powers ended in 1999, when key parts were repealed by the Gramm-Leach-Bliley Act. This new law had the goal of encouraging competition in banking, investment services and insurance, by permitting common ownership by financial conglomerates.

Protecting society against risky investment activities on the part of government-insured institutions is a good thing. And competition in providing financial services is a good thing. But the two goals can be in conflict and have to be balanced, and the consensus as to which should prevail will oscillate from time to time. **So in addition to**

there not being perfect solutions, there also may not be permanent solutions. That's why crises will recur and history will continue to rhyme.

Politics as Usual

Few phrases strike terror in the hearts of businesspeople and many just-plain-citizens more than the three little words that are the title of this section. The other day, a friend with high-up experience explained the facts of life in Washington. He organized his observations into the "Three P's."

- **Policy** is fashioned through intellectual debate conducted on a high plane. Well-meaning people can disagree, but policy analysis follows from facts and underlying ideology in a relatively straightforward way.
- **Process** is the mechanism through which policy is turned into action. It is complex and arcane and the exclusive province of people with experience in Washington.
- **Politics** shapes the law that policy becomes. My friend had lots of words for it, but the one that stood out to me was "distasteful."

As an aside, my friend laid out an important difference between government and business, in which he's also highly experienced. **In business, he says, everyone's main goal is the success of the company.** Contributing to the success of the company enables an individual to demonstrate ability and thus rise in the organization. Success for the company creates a pool of profits from which the individual can be well paid. It also amounts to a "win" for a team of which every person wants to be a member.

But in government, success is hard to measure, difficult to connect to any one individual's contribution, and slow in coming. Thus it's hard to view success for the government as constituting elected officials' primary motivation. Instead, the most important thing is getting re-elected. That personal, short-term consideration can have nothing to do with the long-term well-being of the nation. This is especially true in the House of Representatives, he says, where two-year terms mean the members are never done running for re-election.

Despite the crisis facing the country and the crying need for prompt action, we're seeing a good dose of politics as usual. YouTube provides an up-close look at this stuff. It also gives politicians the audience many seem to crave.

Today a lynch-mob attitude prevails toward bankers, mortgage lenders and credit-rating agencies. I'm not saying a lot of it isn't deserved, but it still can be overdone. It's always good political theater to pile on a purported villain, whether through a perp-walk for handcuffed inside traders in 1986 or a televised congressional hearing for bankers in 2009.

Check out Congress's grilling of bankers on YouTube and you'll see what I think is vilification and *ad hominem* attack ("appealing to one's prejudices, emotions, or special

interests rather than to one's intellect or reason" – Random House Dictionary) intended for public consumption. One congressman told Vikram Pandit, Citibank's CEO, he was amazed by a deal the bank had made: "The government gets \$7 billion in preferred stock and the government's on the hook for \$250 billion of losses. . . . You tell me, Mr. Pandit: where can I get a deal like this?" Pandit explained that it was insurance: for a premium of \$7 billion, Citibank got a policy covering \$301 billion of mortgage securities, with Citi taking the first \$30 billion of losses and 10% of any losses beyond that.

Should it come as a surprise that an insurance policy costs significantly less to buy than the amount of risk assumed by the insurer? If it didn't, why would anyone buy one? Under this policy, Citi will lose money if there aren't \$38 billion in losses (in which case Citi would receive nothing on the first \$30 billion but 90% of the next \$8 billion, so proceeds would be equal to the \$7 billion premium it had paid). Was this deal really such a giveaway? And should the Congressman really be surprised to learn the government has a preference for seeing Citi survive and is willing to cut it a good deal?

On the campaign trail and in victory, President Obama called for non-partisanship and united action. With Democrats controlling the White House and Congress, to him that means Republicans should vote in favor of solutions crafted primarily by Democrats. So far, it's not happening. On the stimulus package, only three of the 217 Republican votes in Congress – just over one percent – were cast with the Democratic majority. (And only seven of the 308 Democratic votes went with the Republicans.) Not much aisle crossing in either direction. Of course, there are lots of reasons why broad agreement is rarely seen:

- Genuine **ideological differences** exist between individuals and between parties. Some want an expanded government to fix problems, and others prefer to rely on free markets to do so. Some view increased government spending as holding the key to the solution, and others prefer to reduce taxes. Some want to rescue weak financial institutions, and others want only the strongest, best-run to survive. Thus, failing to go along with the majority isn't necessarily a sign of a character flaw.
- There are also valid **differences in motivation**. The president is a national officer whose job it is to find an overall solution. But legislators are elected locally to represent local interests, and those can diverge from the interests of other regions or the nation. It shouldn't come as a surprise that they push for particular benefits for their constituents.
- Finally there comes **self-interest**. The truth is that each party has the underlying goal of wanting to elect its members and make the other side look bad. And even if it's needed to solve a grave national problem, a conservative answer might be repugnant and unacceptable to voters in a liberal district, and vice versa. Thus, doing the "right thing" can be tantamount to political suicide. How many elected officials will choose the latter?

Today's Rhetoric

I think people in government who're addressing the situation have a difficult row to hoe:

- First and most immediately, they've had to play up the emergency in order to convince legislators (and the voters who put them in office) that the situation is dire and strong action is required. Thus we've heard words like "catastrophe," "collapse" and "worst since the Great Depression."
- Second, however, they're well advised to play down the threat. Franklin D. Roosevelt receives a lot of credit for having said, "The only thing we have to fear is fear itself." Given the crucial role of confidence in the functioning of an economy, it's not a great idea to spread panic. The rational response of frightened people is to save rather than spend, and to sell investments rather than buy, making things worse.
- Third, the President likely wants to create modest expectations. If there's a feeling that a valid response should work right away, slow progress will look like failure. No one wants consumers and businesses to further pull in their horns if economic recovery isn't forthcoming in 2009.

It's hard not to be sympathetic to this dilemma. It shows another of the ways in which conflicting goals have to be compromised in the real world of economics and politics.

The Bottom Line

There are so many moving parts to the current situation – and to its causes and what we hope will be its solution – that I've tried to boil things down to the essentials. **In order to right the system and get the economy moving forward again, I think three main things have to be accomplished:**

- **Our economy and its component parts have to be delevered;**
- **The vast destruction of capital has to be dealt with; and**
- **Confidence has to be restored.**

Here's how Paul Krugman described the challenge in *The New York Times* of February 16:

For most of the last decade America was a nation of borrowers and spenders, not savers. . . .

Yet until very recently Americans believed they were getting richer, because they received statements saying that their houses and stock portfolios were appreciating in value faster than their debts were increasing. . . .

Then reality struck, and it turned out that the worriers had been right all along. The surge in asset values had been an illusion – but the surge in debt had been all too real. . . .

. . . this is a broad-based mess. Everyone talks about the problems of the banks, which are indeed in even worse shape than the rest of the system. But the banks aren't the only players with too much debt and too few assets; the same description applies to the private sector as a whole.

As the great American economist Irving Fisher pointed out in the 1930s, the things people and companies do when they realize they have too much debt tend to be self-defeating when everyone tries to do them at the same time. Attempts to sell assets and pay off debt deepen the plunge in asset prices, further reducing net worth. Attempts to save more translate into a collapse of consumer demand, deepening the economic slump.

. . . Government officials understand the issue: we need to “contain what is a very damaging and potentially deflationary spiral,” says Lawrence Summers, a top Obama economic adviser.

Debt has to be reduced, and it's happening (other than at the federal level, of course). But the way it happens is usually unpleasant: bankruptcies, foreclosures and debt restructurings. **“Debt reduction” sounds like a good thing, but it's likely to be accompanied by the painful loss of the assets that had been bought with borrowed money.**

Many assets are worth far less than they used to be – that's one of the main reasons why the debt load has become unbearable and has to be reduced. **Investors, consumers, homeowners and financial institutions will have to rebuild their capital as they – and the economy – attempt to again move ahead.**

And confidence has to be rebuilt, too. **The willingness to borrow, spend and invest will rebound only when people believe incomes and asset values will resume their growth.**

In the past, we've seen a standard pattern unfold, with the best examples falling in the corporate debt arena. **Once denial ends and people accept capital destruction as a fact, restructurings can take place in which debt is discharged and ownership changes hands. The transition of assets to new owners, who may have lower cost bases and the ability to inject additional capital, brings the possibility of attractive returns, the onset of which restores interest in investing. It seems inescapable that this pattern will be a major feature of the next few years.**

The government's actions clearly are aimed at accomplishing the three things I say we need. Some will work, and some won't. **I believe that, eventually, the combination of things they try – along with the pattern described above and the positive bent that**

underlies the free market system – will return us to an upward trajectory. It just won't be easy, quick or painless.

And that's why I think the investment decisions we make today must emphasize value, survivability and staying power. I readily acknowledge that assuring survival in bad times is inconsistent with return maximization in good times. Insistence on these three things won't produce the greatest rewards if the economy and markets surprise on the upside, but that's not my main concern.

Given the uncertainty present today, it's hard enough to find investments that can be relied on to deliver solid returns in good times but also assure survival in bad. **In that interest, we've always been willing to cede to others much of that part of the return distribution lying between "solid" and "maximum." This time is no different.**

March 5, 2009

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Memo to: Oaktree Clients
From: Howard Marks
Re: So Much That's False and Nutty

As reported in *The New York Times* of May 5, Warren Buffett told the crowd at this year's Berkshire Hathaway annual meeting:

There is so much that's false and nutty in modern investing practice and modern investment banking. If you just reduced the nonsense, that's a goal you should reasonably hope for.

As we look back at the causes of the crisis approaching its second anniversary – and ahead to how investors might conduct themselves better in the future – Buffett's simple, homespun advice holds the key, as usual. I agree that investing practice went off the rails in several fundamental ways. Perhaps this memo can help get it back on.

The Lead-up: Progress and Missteps

Memory dims with the passage of time, but when I think back to the investment arena I entered forty-plus years ago, it seems very different from that of 2003-07. Institutional investing was done mainly by bank investment departments (like the one I was part of), insurance companies and investment counselors – a pretty dull bunch. And as I like to point out when I speak to business school classes, “famous investor” was an oxymoron – few investment managers were well known, chosen for magazine covers or listed among the top earners.

There were no swaps, index futures or listed options. Leverage wasn't part of most institutional investors' arsenal . . . or vocabulary. Private equity was unknown, and hedge funds were too few and outré to matter. Innovations like quantitative investing and structured products had yet to arrive, and few people had ever heard of “alpha.”

Return aspirations were modest. Part of this likely was attributable to the narrow range of available options: for the most part stocks and bonds. Stocks would average 9-10% per year, it was held, but we might put together a portfolio that would do a little better. And the admissible bonds were all investment grade, yielding moderate single digits.

We wanted to earn a good return, limit the risks, beat the Dow and our competitors, and retain our clients. But I don't remember any talk of “maximization,” or anyone trying to “shoot the lights out.” And by the way, no one had ever heard of performance fees. Quite a different world from that of today. Perhaps it would constitute a service if I pulled together a list of some of the developments since then:

- In the mid-1960s, **growth investing** was invented, along with the belief that if you bought the stocks of the “nifty-fifty” fastest-growing companies, you didn’t have to worry about paying the right price.
- The first of the **investment boutiques** was created in 1969, as I recall, when highly respected portfolio managers from a number of traditional firms joined together to form Jennison Associates. For the first time, institutional investing was sexy.
- We started to hear more about **investment personalities**. There were the “Oscars” (Schafer and Tang) and the “Fredes” (Carr, Mates and Alger) – big personalities with big performance, often working outside the institutional mainstream.
- In the early 1970s, **modern portfolio theory** began to seep from the University of Chicago to Wall Street. With it came indexation, risk-adjusted returns, efficient frontiers and risk/return optimization.
- Around 1973, put and call **options** escaped from obscurity and began to trade on exchanges like the Chicago Board Options Exchange.
- Given options’ widely varying time frames, strike prices and underlying stocks, a tool for valuing them was required, and the **Black-Scholes model** filled the bill.
- A small number of **leveraged buyouts** took place starting in the mid-1970s, but they attracted little attention.
- 1977-79 saw the birth of the **high yield bond market**. Up to that time, bonds rated below investment grade couldn’t be issued. That changed with the spread of the argument – associated primarily with Michael Milken – that incremental credit risk could responsibly be borne if offset by more-than-commensurate yield spreads.
- Around 1980, **debt securitization** began to occur, with packages of mortgages sliced into securities of varying risk and return, with the highest-priority tranche carrying the lowest yield, and so forth. This process was an example of disintermediation, in which the making of loans moved out of the banks; 25 years later, this would be called the **shadow banking system**.
- One of the first “quant” miracles came along in the 1980s: **portfolio insurance**. Under this automated strategy, investors could ride stocks up but avoid losses by entering stop-loss orders if they fell. It looked good on paper, but it failed on Black Monday in 1987 when brokers didn’t answer their phones.
- In the mid- to late 1980s, the ability to borrow large amounts of money through high yield bond offerings made it possible for minor players to effect buyouts of large, iconic companies, and “**leverage**” became part of investors’ everyday vocabulary.
- When many of those buyouts proved too highly levered to get through the 1990 recession and went bust, investing in **distressed debt** gained currency.
- Real estate had boomed because of excessive tax incentives and the admission of real estate to the portfolios of S&Ls, but it collapsed in 1991-92. When the Resolution Trust Corporation took failed properties from S&Ls and sold them off, “**opportunistic**” **real estate** investing was born.
- Mainstream investment managers made the big time, with Peter Lynch and Warren Buffett becoming famous for consistently beating the equity indices.
- In the 1990s, **emerging market investing** became the hot new thing, wowing people until it took its knocks in the mid- to late 1990s due to the Mexican peso devaluation, Asian financial crisis and Russian debt disavowal.

- **Quant investing** arrived, too, achieving its first real fame with the success of Long-Term Capital Management. This Nobel Prize-laden firm used computer models to identify fixed income arbitrage opportunities. Like most other investment miracles, it worked until it didn't. Thanks to its use of enormous leverage, LTCM melted down spectacularly in 1998.
- Investors' real interest in the last half of the '90s was in **common stocks**, with the frenzy accelerating but narrowing to **tech-media-telecom stocks** around 1997 and narrowing further to **Internet stocks** in 1999. The "limitless potential" of these instruments was debunked in 2000, and the equity market went into its first three-year decline since the Great Crash of '29.
- **Venture capital funds**, blessed with triple-digit returns thanks to the fevered appetite for tech stocks, soared in the late 1990s and crashed soon thereafter.
- After their three-year slump, the loss of faith in common stocks caused investors to shift their hopes to **hedge funds** – "absolute return" vehicles expected to make money regardless of what went on in the world.
- With the bifurcation of strategies and managers into "beta-based" (market-driven) and "alpha-based" (skill-driven), investors concluded they could identify managers capable of **alpha investing**, emphasize it, perhaps synthesize it, and "port" or carry it to their portfolios in additive combinations.
- **Private equity** – sporting a new label free from the unpleasant history of "leveraged buyouts" – became another popular alternative to traditional stocks and bonds, and funds of \$20 billion and more were raised at the apex in 2006-07.
- Wall Street came forward with a plan to package prosaic, reliable home mortgages into **collateralized debt obligations** – the next high-return, low-risk free lunch – with help from tranching, securitization and selling onward.
- The key to the purported success of this latest miracle lay in **computer modeling**. It quantified the risk, assuming that mortgage defaults would remain uncorrelated and benign as historically had been the case. But because careless mortgage lending practices unknowingly had altered the probabilities, the default experience turned out to be much worse than the models suggested or the modelers thought possible.
- Issuers of **collateralized loan obligations** bought corporate loans using the same processes that had been applied to CDOs. Their buying facilitated vast issuance of syndicated bank loans carrying low interest rates and few protective covenants, now called **leveraged loans** because the lending banks promptly sold off the majority.
- Options were joined by futures and swaps under a new heading: **derivatives**. Heralded for their ability to de-risk the financial system by shifting risk to those best able to bear it, derivatives led to vast losses and something new: counterparty risk.
- The common thread running through hedge funds, private equity funds and many other of these investment innovations was **incentive compensation**. Expected to align the interests of investment managers and their clients, in many cases it encouraged excessive risk taking.
- Computer modeling was further harnessed to create "**value at risk**" and other risk management tools designed to quantify how much would be lost if the investment environment soured. This fooled people into thinking risk was under control – a belief that, if acted on, has the potential to vastly increase risk.

At the end of this progression we find an institutional investing world that bears little resemblance to the quaint cottage industry with which the chronology began more than forty years ago. Many of the developments served to increase risk or had other negative implications, for investors individually and for the economy overall. In the remainder of this memo, I'll discuss these trends and their ramifications.

Something for Everyone

One thing that caused a lot of people to lose money in the crisis was the popularization of investing. Over the last few decades, as I described in "The Long View" (January 2009), investing became widespread. "Less than 10% of adults owned stocks in the 1950s, in contrast to 40% today." (*Economics and Portfolio Strategy*, June 1, 2009). Star investors became household names and were venerated. "How-to" books were big sellers, and investors graced the covers of magazines. Television networks were created to cover investing 24/7, and Jim Cramer and the "Money Honey" became celebrities in their own right.

It's interesting to consider whether this "democratization" of investing represented progress, because in things requiring special skill, it's not necessarily a plus when people conclude they can do them unaided. The popularization – with a big push from brokerage firms looking for business and media hungry for customers – was based on success stories, and it convinced people that "anyone can do it." **Not only did this overstate the ease of investing, but it also vastly understated the danger.** ("Risk" has become such an everyday word that it sounds harmless – as in "the risk of underperformance" and "risk-adjusted performance." Maybe we should switch to "danger" to remind people what's really involved.)

To illustrate, I tend to pick on Wharton Professor Jeremy Siegel and his popular book "Stocks for the Long Run." Siegel's research was encyclopedic and supported some dramatic conclusions, perhaps foremost among them his showing that there's never been a 30-year period in which stocks didn't outperform cash, bonds and inflation. This convinced a lot of people to invest heavily in stocks. But even if his long-term premise eventually holds true, anyone who invested in the S&P 500 ten years ago – and is now down 20% – has learned that 30 years can be a long time to wait.

The point is that not everyone is suited to manage his or her own investments, and not everyone should take on uncertain investments. The success of Bernard Madoff's Ponzi scheme shows that even people who are wealthy and presumed sophisticated can overlook risks. Might that be borne in mind the next time around?

At Ease with Risk

Risk is something every investor should think about constantly. We know we can't expect to make money without taking chances. The reason's simple: if there was a risk-

free way to make good money – that is, a path to profit free from downside – everyone would pursue it without hesitation. That would bid up the price, bring down the return and introduce the risk that accompanies elevated prices.

So yes, it's true that investors can't expect to make much money without taking risk. But that's not the same as saying risk taking is sure to make you money. As I said in "Risk" (January 2006), if risky investments always produced high returns, they wouldn't be risky.

The extra return we hope to earn for holding stocks rather than bonds is called an equity risk premium. The additional promised yield on high yield bonds relative to Treasuries is called a credit risk premium. All along the upward-sloping capital market line, the increase in potential return represents compensation for bearing incremental risk. Except for those people who can generate "alpha" or access alpha managers, investors shouldn't plan on getting added return without bearing incremental risk. And for doing so, they should demand risk premiums.

But at some point in the swing of the pendulum, people usually forget that truth and embrace risk taking to excess. In short, in bull markets – usually when things have been going well for a while – people tend to say, "Risk is my friend. The more risk I take, the greater my return will be. I'd like more risk, please."

The truth is, risk tolerance is antithetical to successful investing. When people aren't afraid of risk, they'll accept risk without being compensated for doing so . . . and risk compensation will disappear. This is a simple and inevitable relationship. When investors are unworried and risk-tolerant, they buy stocks at high p/e ratios and private companies at high EBITDA multiples, and they pile into bonds despite narrow yield spreads and into real estate at minimal "cap rates."

In the years leading up to the current crisis, it was "as plain as the nose on your face" that prospective returns were low and risk was high. In simple terms, there was too much money looking for a home, and too little risk aversion. Valuation parameters rose and prospective returns fell, and yet the amount of money available to managers grew steadily. Investors were attracted to risky deals, complex structures, innovative transactions and leveraged instruments. In each case, they seemed to accept the upside potential and ignore the downside.

There are few things as risky as the widespread belief that there's no risk, because it's only when investors are suitably risk-averse that prospective returns will incorporate appropriate risk premiums. Hopefully in the future (a) investors will remember to fear risk and demand risk premiums and (b) we'll continue to be alert for times when they don't.

Embracing Illiquidity

Among the risks faced by the holder of an investment is the chance that if liquidity has dried up at a time when it has to be sold, he'll end up getting paid less than it's worth.

Illiquidity is nothing but another source of risk, and it should be treated no differently:

- All else being equal, investors should prefer liquid investments and dislike illiquidity.
- Thus, before making illiquid investments, investors should ascertain that they're being rewarded for bearing that risk with a sufficient return premium.
- Finally, out of basic prudence, investors should limit the proportion of their portfolios committed to illiquid investments. There are some risks investors shouldn't take regardless of the return offered.

But just as people can think of risk as a plus, so can they be attracted to illiquidity, and for basically the same reason. There is something called an illiquidity premium. It's the return increment investors should receive in exchange for accepting illiquidity. But it'll only exist if investors prefer liquidity. If they're indifferent, the premium won't be there.

Part of the accepted wisdom of the pre-crisis years was that long-term institutional investors should load up on illiquid investments, capitalizing on their ability to be patient by garnering illiquidity premiums. In 2003-07, so many investors adopted this approach that illiquidity premiums became endangered. For example, as of the middle of 2008, the average \$1 billion-plus endowment is said to have had investments in and undrawn commitments to the main illiquid asset classes (private equity, real estate and natural resources) equal to half its net worth. Some had close to 90%.

The willingness to invest in locked-up private investment funds is based on a number of "shoulds." Illiquid investments should deliver correspondingly higher returns. Closed-end investment funds should call down capital gradually. Cash distributions should be forthcoming from some funds, enabling investors to meet capital calls from others. And a secondary market should facilitate the sale of positions in illiquid funds, if needed, at moderate discounts from their fair value. But things that should happen often fail to happen. That's why investors should view potential premium returns skeptically and limit the risk they bear, including illiquidity.

Comfortable with Complexity

Investors' desire to earn money makes them willing to do things they haven't done before, especially if those things seem modern and sophisticated. Technological complexity and higher math can be seductive in and of themselves. And good times and rising markets encourage experimentation and erase skepticism. These factors allow Wall Street to sell innovative products in bull markets (and only in bull markets). But these innovations can be tested only in bear markets . . . and invariably they are.

Many of the investment techniques that were embraced in 2003-07 represented quantitative innovations, and people seemed to think of that as an advantage rather than a source of potential risk. Investors were attracted to black-box quant funds, highly levered mortgage securities critically dependent on computer models, alchemical portable alpha, and risk management based on sketchy historical data. The dependability of these things was shaky, but the risks were glossed over. As Alan Greenspan wrote in *The Wall Street Journal* of March 11:

It is now very clear that the levels of complexity to which market practitioners at the height of their euphoria tried to push risk-management techniques and products were too much for even the most sophisticated market players to handle properly and prudently.

Warren Buffett put it in simpler terms at this year's Berkshire meeting. **"If you need a computer or a calculator to make the calculation, you shouldn't buy it."** And Charlie Munger added his own slant: "Some of the worst business decisions I've ever seen are those with future projections and discounts back. It seems like the higher mathematics with more false precision should help you, but it doesn't. They teach that in business schools because, well, they've got to do something."

To close on this subject, I want to share a quote I recently came across from Albert Einstein. I've often argued that the key to successful investing lies in subjective judgments made by experienced, insightful professionals, not machinable processes, decision rules and algorithms. I love the way Einstein put it:

Not everything that can be counted counts, and not everything that counts can be counted.

Relying on Ratings

My memos on the reasons for the crisis, like "Whodunit" (February 2008), show that there's more than enough blame to go around and lots of causes to cite. **But if you boil it down, there was one indispensable ingredient in the process that led to trillions of dollars of losses: misplaced trust in credit ratings.** The explanation is simple:

- Competitive pressure for profits caused financial institutions to try to keep up with the leaders. As is normal in good times, the profit leaders were those who used the most leverage.
- Thus institutions sought to maximize their leverage, but the rules required that the greatest leverage be used only with investments rated triple-A.
- A handful of credit rating agencies had been designated by the government as Nationally Recognized Statistical Rating Organizations, despite their highly imperfect track records.
- The people who guard the financial henhouse often have a tough time keeping up with the foxes' innovations. Whereas traditional bond analysis was a relatively

simple matter, derivatives and tiered securitizations were much more complex. This allowed rating agency employees to be manipulated by the investment banks' quantitatively sophisticated and highly compensated financial engineers.

- The rating agencies proved too naïve, inept and/or venal to handle their assigned task.
- Nevertheless, **financial institutions took the ratings at face value, enabling them to pursue the promise of highly superior returns from supposedly riskless, levered-up mortgage instruments. This deal clearly was too good to be true, but the institutions leapt in anyway.**

It all started with those triple-A ratings. For his graduation from college this year, Andrew Marks wrote an insightful thesis on the behavior that gave rise to the credit crisis. I was pleased that he borrowed an idea from “Whodunit”: “if it’s possible to start with 100 pounds of hamburger and end up selling ten pounds of dog food, 40 pounds of sirloin and 50 pounds of filet mignon, the truth-in-labeling rules can’t be working.” That’s exactly what happened when mortgage-related securities were rated.

Investment banks took piles of residential mortgages – many of them subprime – and turned them into residential mortgage-backed securities (RMBS). The fact that other tranches were subordinated and would lose first allowed the rating agencies to be cajoled into rating a lot of RMBS investment grade. Then RMBS were assembled into collateralized debt obligations, with the same process repeated. In the end, heaps of mortgages – each of which was risky – were turned into CDO debt, more than 90% of which was rated triple-A, meaning it was supposed to be almost risk-free.

John Maynard Keynes 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.” Speculators who bought the low end of the CDO barrel with their eyes open to the risk suffered total losses on a small part of their capital. But the highly levered, esteemed investing institutions that accepted the higher ratings without questioning the mortgage alchemy lost large amounts of capital, because of the ease with which they’d been able to lever holdings of triple-A and “super-senior” CDOs. Ronald Reagan said of arms treaties, “Trust, then verify.” If only financial institutions had done the same.

The rating agencies were diverted from their mission by a business model that made them dependent on security issuers for their revenues. This eliminated their objectivity and co-opted them into the rating-maximization process. Regardless of that happening, however, it’s clear that the stability of our financial institutions never should have been allowed to rely so heavily on the competence of a few for-profit (and far-from-perfect) rating agencies. **In the future, when people reviewing the crisis say, “If only they had . . . ,” the subject will often be credit ratings. Bottom line: investors must never again abdicate the essential task of assessing risk. It’s their number-one job to perform thorough, skeptical analysis.**

The More You Bet . . .

If I had to choose a single phrase to sum up investor attitudes in 2003-07, it would be the old Las Vegas motto: “The more you bet, the more you win when you win.”

Casino profits ride on getting people to bet more. In the financial markets just before the crisis, players needed no such encouragement. They wanted to bet more, and the availability of leverage helped them do so.

One of the major trends embedded in the chronology on pages two and three was toward increasing the availability of leverage. Now, I’ve never heard of any of Oaktree’s institutional clients buying on margin or taking out a loan to make investments. It might not be considered “normal” for fiduciaries, and tax-exempt investors would have to worry about Unrelated Business Taxable Income.

None of us go out and buy Intel chips, but we’ve all seen commercials designed to get us to buy products with “Intel inside.” In the same way, **investors became increasingly able to buy investment products with leverage inside . . . that is, to participate in levered strategies rather than borrow explicitly to make investments.** Think about these elements from my earlier list of investment developments:

- Investors who would never buy stocks on margin were able to invest in private equity funds that would buy companies on leverage of four times or more.
- The delayed and irregular nature of drawdowns caused people who had earmarked \$100 for private investment funds to make commitments totaling \$140.
- Options, swaps and futures – in fact, many derivatives – are nothing but ways for investors to access the return on large amounts of assets with little money down.
- Many hedge funds used borrowings or derivatives to access the returns on more assets than their capital would allow them to buy.
- When people wanted to invest \$100 in markets with skill-derived return bolted on, “portable alpha” had them invest \$90 in hedge funds with perceived alpha and the rest in futures covering \$100 worth of the passive market index. This gave them a stake in the performance of \$190 of assets for every \$100 of capital.

Clearly, each of these techniques exposed investors to the gains or losses on increased amounts of assets. If that’s not leverage, what is? In fact, an article entitled “Harvard Endowment Chief Is Earning Degree in Crisis Management” in *The New York Times* of February 21 said of Harvard, “The endowment was squeezed partly because **it had invested more than its assets . . .**” (emphasis added). I find this statement quite remarkable, and yet no one has remarked on it to me.

It shouldn’t be surprising that people engaging in these levered strategies made more than others when the market rose. But 2008 showed the flip side of that equation in action. **In the future, investors should consider whether they really want to lever their capital or just invest the amount they have.**

Sharing the Wealth

Apart from the increasing use of leverage, another trend that characterized the five years before the crisis was the widespread imposition of incentive fees.

In the 1960s, at the start of my chronology, only hedge funds commanded incentive fees, and there were too few for most people to know or care about. But fee arrangements that can be simplified as “two-and-twenty” flowered with private equity in the 1980s, distressed debt, opportunistic real estate and venture capital funds in the 1990s, and hedge funds in the 2000s. Soon they were everywhere.

Here are my basic thoughts on this sort of arrangement. (Oaktree receives incentive compensation on roughly half its assets; my objection isn't with regard to the fees themselves, but rather the way they've been applied.)

- **It seems obvious that incentive fees should go only to managers with the skill needed to add enough to returns to more than offset the fees – other than through the mere assumption of incremental risk.** For example, after a high yield bond manager's .50% fee, a 12% gross return becomes 11.5% net. A credit hedge fund charging a 2% management fee and 20% of the profits would have to earn a 16.375% gross return to net 11.5%. That's 36% more return. **How many managers in a given asset class can generate this incremental 36% other than through an increase in risk? A few? Perhaps. The majority? Never.**
- **Thus, incentive fee arrangements should be exceptional, but they're not.** These fees didn't go to just the proven managers (or the ones whose returns came from skill rather than beta); they went to everyone. If you raised your hand in 2003-07 and said “I'm a hedge fund manager,” you got a few billion to manage at two-and-twenty, even if you didn't have a record of successfully managing money over periods that included tough times.
- The run-of-the-mill manager's ease of obtaining incentive fees was enhanced each time a top manager capped a fund. As I wrote in “Safety First . . . But Where?” (April 2001), “When the best are closed, the rest will get funded.”
- In fact, whereas two-and-twenty was unheard-of in the old days, it became the norm in 2003-07. This enabled a handful of managers with truly outstanding records to demand profit shares ranging up to 50%.
- Clients erred in using the term “alignment of interests” to describe the effect of incentive compensation on their relationships with managers. Allowing managers to share in the upside can bring forth best efforts, but it can also encourage risk bearing instead of risk consciousness. Most managers just don't have enough money to invest in their funds such that loss of it could fully balance their potential fees and upside participation. **Instead of alignment, then, incentive compensation must be viewed**

largely as a “heads we win; tails you lose” arrangement. Clearly, it must be accorded only to the few managers who can be trusted with it.

- **Finally, the responsibility for overpaying doesn’t lie with the person who asks for excessive compensation, but rather with the one who pays it.** How many potential LPs ever said, “He may be a great manager, but he’s not worth that fee.” I think most applied little price discipline, as they were driven by the need to fill asset class allocations and/or the fear that if they said no, they might miss out on a good thing (more on this subject later).

I’m asked all the time nowadays what I expect to happen with investment manager compensation. First, I remind people that what should happen and what will happen are two different things. Then I make my main point: there should be much more differentiation. **Whereas in past years everyone’s fees were generous and pretty much the same, the post-2007 period is providing an acid test that will show who helped their clients and who didn’t.** Appropriate compensation adjustments should follow.

Managers who actually helped their clients before and during this difficult period – few in number, I think – will deserve to be very well compensated, and their services could be in strong demand. The rest should receive smaller fees or be denied incentive arrangements, and some might turn to other lines of work. Oaktree hopes to be among the former group. We’ll see.

Ducking Responsibility

The inputs used by a business to make its products are its costs. The money it receives for its output are its revenues. The difference between revenues and costs are its profits. At the University of Chicago, I was taught that by maximizing profits – that is, maximizing the excess of output over input – a company maximizes its contribution to society. This is among the notions that have been dispelled, exposing the imperfections of the free-market system. (Hold on; I’m not saying it’s a bad system, just not perfect.)

When profit maximization is exalted to excess, ethics and responsibility can go into decline, a phenomenon that played a substantial role in getting us where we are. The pursuit of short-term profit can lead to actions that are counterproductive for others, for society and for the long run. For example:

- A money manager’s desire to add to assets under management, and thus profits, can lead him to take in all the money he can. But when asset prices and risks are high and prospective returns are low, this clearly isn’t good for his clients.
- Selling financial products to anyone who’ll buy them, as opposed to those for whom they’re right, can put investors at unnecessary risk.
- And cajoling rating agencies into assigning the highest rating to debt backed by questionable collateral can put whole economies in jeopardy, as we’ve seen.

One of the concepts that governed my early years, but about which I've heard little in recent years, is "fiduciary duty." Fiduciary duty is the obligation to look out for the welfare of others, as opposed to maximizing for yourself. It can be driven by ethics or by fear of legal consequences; either way, it tends to cause caution to be emphasized.

When considering a course of action, we should ask, "Is it right?" Not necessarily the cleverest practice or the most profitable, but the right thing? The people I think of perverting the mortgage securitization process never wondered whether they were getting an appropriate rating, but whether it was the highest possible. Not whether they were doing the right thing for clients or society, but whether they were wringing maximum proceeds out of a pile of mortgage collateral and thus maximizing profits for their employers and bonuses for themselves.

A lot of misdeeds have been blamed on excessive emphasis on short-term results in setting compensation. The more compensation stresses the long run, the more it creates big-picture benefits. Long-term profits do more good – for companies, for business overall and for society – than does short-term self-interest.

Focusing on the Wrong Risk

The more I've thought about it over the last few months, the more I've concluded that investors face two main risks: (1) the risk of losing money and (2) the risk of missing opportunity. Investors can eliminate one or the other, but not both. More commonly, they must consider how to balance the two. How they do so will have a great impact on their results. This is the old dilemma – fear or greed? – that people talk about so much. It's part of the choice between offense and defense that I often stress (see, for example, "What's Your Game Plan?" September 2003).

The problem is that investors often fail to strike an appropriate balance between the two risks. In a pattern that exemplifies the swing of the pendulum from optimistic to pessimistic and back, investors regularly oscillate between extremes at which they consider one to the exclusion of the other, not a mixture of the two.

One of the ways I try to get a sense for what's going on is by imagining the conversations investors are having with each other . . . or with themselves. In 2003-07, with most investors worried only about achieving returns, I think the conversation went like this: "I'd better not make less than my peers. Am I behaving as aggressively as I should? Am I using as much leverage as my competitor? Have I shifted enough from stocks and bonds to alternatives, or am I being an old fogey? If my commitments to private equity are 140% of the amount I actually want to invest, is that enough, or should I do more?"

Few people seemed to worry about losses. Or if they were worried, they played anyway, fearing that if they didn't, they'd be left behind. That must be what drove Citigroup's Chuck Prince when he said, "as long as the music's playing, you've got to get up and

dance. We're still dancing." **The implication's clear: No worries; high prices. No risk aversion; no risk premiums.** Certainly that describes the markets in 2003-07.

In the fourth quarter of 2008, when asset prices were collapsing, I imagined a very different conversation from that of 2003-07, with most investors saying, "I don't care if I never make another dollar in the market; I just don't want to lose any more. Get me out!" Attitudes toward the two risks were still unbalanced, but in the opposite direction.

Just as risk premiums disappear when risk is ignored, so can prospective returns soar when risk aversion is excessive. In late 2008, economic fundamentals were terrible; technical conditions consisted of forced selling and an absence of buyers; and market psychology melted down. Risk aversion predominated, and fear of missing out disappeared. These are the conditions under which assets are most likely to be available for purchase at prices way below their fair value. They're also the conditions in which most people go on buying strikes.

In the future, investors should do a better job of balancing the fear of losing money and the fear of missing out. My response is simple: Good luck with that.

Pursuing Maximization

When markets are rising and investors are obsessed with the fear of missing out, the desire is for maximum returns. Here's the inner conversation I imagine: "I need a return of 8% a year. But I'd rather have 10%. 14% would be great, and the possibility of 16% warrants adding to my risk. It's worth using leverage for a shot at 20%, and with twice as much leverage, I might get 24%."

In other words, more is better. And of course it is . . . except that to pursue higher returns, you have to give up something. That something is safety. But in hot times, no one worries about losing money, just missing out. So they try to maximize.

There should be a point at which investors say, "I need 8%, and it would be great if I could get 16%. But to try, I would have to do things that expose me to excessive loss. I'll settle for a safer 10% instead." **I've labeled this concept "good-enough returns."** **It's based on the belief that the possibility of more isn't always better. There should be a point at which investors decline to take more risk in the pursuit of more return, because they're satisfied with the return they expect and would rather achieve that with high confidence than try for more at the risk of falling short (or losing money).**

Most investors will probably say that in 2003-07, they didn't blindly pursue maximization; it was the other guys. But someone did it, and we're living with the consequences. **I like it better when society balances risk and return rather than trying to maximize. Less gain, perhaps, but also less pain.**

* * *

“Apropos of nothing,” as my mother used to say, I’m going to use the opportunity provided by this memo to discuss market conditions and the outlook. On the plus side:

- We’ve heard a lot recently about “green shoots”: mostly cases where things have stopped getting worse or the rate of decline is slowing. A few areas have shown actual improvement, such as consumer confidence and durable goods orders. It’s important when you consider these improvements, however, to bear in mind that when you get deep into a recession, the comparisons are against depressed periods, and thus easier.
- It’s heartening to see the capital markets open again, such that banks can recapitalize and borrowers can extend maturities and delever. Noteworthily, Michael Milken and Jonathan Simons wrote in *The Wall Street Journal* of June 20 that, “Global corporations have raised nearly \$2 trillion in public and private markets this year . . .”
- Investor opinion regarding markets and the government’s actions has grown more positive, and as Bruce Karsh says, “Armageddon is off the table.” (He and I both felt 6-9 months ago that a financial system meltdown absolutely couldn’t be ruled out.)

These positives are significant, but there also are many unresolved negatives:

- Business is still terrible. Sales trends are poor. Where profits are up, it’s often due to cost-cutting, not growth. (Remember, one man’s economy measure is another’s job loss – not always a plus for the overall picture.)
- Unemployment is still rising, and with incomes shrinking, savings rising as a percentage of shrinking incomes, and credit scarcer, it’s hard to see whose spending will power a recovery.
- The outlook for residential and, particularly, commercial real estate remains poor, with implications for further write-offs on the part of the banks. Ditto for credit card receivables.
- Many companies are likely to experience debt refinancing challenges, defaults, bankruptcies and restructurings.
- Developments such as rising interest rates and rising oil prices have the power to impede a recovery.
- Finally, no one can say with confidence what will be the big-picture ramifications of trillions of dollars of federal deficit spending, or the states’ fiscal crises.

I’m not predicting that these things will turn out badly, merely citing potential negatives that may not be fully reflected in today’s higher asset prices. My greatest concern surrounds the fact that we’re in the middle of an unprecedented crisis, brought on by never-seen-before financial behavior, against which novel remedies are being attempted. And yet many people seem confident that a business-as-usual recovery lies ahead. They’re applying normal lag times and extrapolating normal decline/recovery relationships. **The words of the late Amos Tversky aptly represent my view: “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."

Peter Bernstein, a towering intellect who sadly passed away a month ago, made some important contributions to the way I think about investing. Perhaps foremost among them was his trenchant observation that, "Risk means more things can happen than will happen." **Investors today may think they know what lies ahead, but they should at least acknowledge that risk is high, the range of possibilities is wider than it was ever thought to be, and there are a few that could be particularly unpleasant.**

Unlike 2003-07 when no one worried about risk, or late 2008 when few investors cared about opportunity, the two seem to be in better balance given the revival of risk taking this year. Thus the markets have recovered, with most of them up 30% or more from their bottoms (debt in December and stocks in March).

If you and I had spoken six months ago, we might have reflected on the significant stock market rallies that occurred during the decade-long Great Depression, including a 67% gain in the Dow in 1933. How uncalled-for those rallies appear in retrospect. But now we've had one of our own.

Clearly, improved psychology and risk tolerance have played a big part in the recent rally. These things have strengthened even as economic fundamentals haven't, and that could be worrisome. (On June 23, talking about general resilience – not investor attitudes – President Obama said the American people "...are still more optimistic than the facts alone would justify.") On the other hand, there's good reason to believe that at their lows, security prices had understated the merits. So are prices ahead of fundamentals today, or have they merely recovered from "too low" to "in balance"? There's no way to know for sure.

Unlike the fourth quarter of last year – when assets were depressed by terrible fundamentals, technicals and psychology – they're no longer at giveaway prices. Neither are they clearly overvalued. Maybe we should say "closer to fair."

With price and value in reasonable balance, the course of security prices will largely be determined by future economic developments that defy prediction. Thus I find it hard to be highly opinionated at this juncture. Few things are compelling sells here, but I wouldn't be a pedal-to-the-metal buyer either. On balance, I think better buying opportunities lie ahead.

July 8, 2009

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Memo to: Oaktree Clients
From: Howard Marks
Re: Tell Me I'm Wrong

My readers treat me well. They indulge my penchant for dissecting the past, and they send kind messages of encouragement. To repay their generosity, I'm going to venture into something I usually avoid: the future of the U.S. economy.

This memo won't be about the future in general, just the elements I find worrisome. As I see it, every investor is either predominantly a worrier or predominantly a dreamer. I've come clean many times: I'm a worrier. By saying that, I absolve myself of having to describe the whole future. I'm going to cover the negatives, starting with the immediate and ending with the systemic (some of the latter repeats themes from "What Worries Me," August 28, 2008). For the other side of the story, I'd suggest you consult the optimists who seem to be in charge of the markets these days.

The Near Term

One thing is indisputable: the rally in financial markets worldwide has outpaced the fundamentals. At the beginning of 2009, most onlookers expected a generally weak economy and were concerned that the behavior of consumers and banks would remain conservative. They were 100% right, and fundamentals are still tenuous. And yet, the rally has exceeded all expectations of which I'm aware.

Market participants have grasped at slender "green shoots": things that are declining but at a slower rate, or that have stopped getting worse, or that have begun to improve, albeit anemically (e.g., "At some of the nation's largest lenders, the number of consumer loans that are going bad is starting to level off." *The New York Times*, January 21). Most of the good news falls into those categories; little or nothing has blown anyone's socks off. We haven't seen much economic news that's overwhelmingly positive, despite the fact that (a) today's comparisons are against very weak periods a year ago, (b) our exports have been made cheaper by a dollar that's 10-20% lower, and (c) there's been an enormous amount of government stimulus. The gains being reported are often in tenths of a percent, and the other day my drive-time radio commentator said, "Hirings are almost equal to firings." That doesn't tell me we're in the midst of a strong recovery, or on track for one.

In particular, most companies' sales remain quite weak. The economy is generating very little growth at the so-called "top line" on which Gross Domestic Product is based. Rather, the profit gains being reported have been aided in large part by cost cutting. But "cost cutting" and "productivity gains" are nice-sounding ways of saying companies are getting by with less labor. Thus the employer's productivity gain can be the employee's job loss. It doesn't bode well for

the general welfare, consumer spending or GDP growth if the level of business activity, as seen in revenues, isn't rising; GDP doesn't benefit from profit margin expansion.

Reliance on Government Stimulus

A year or so ago, the government came to the rescue of the economy with massive stimulus. With the Great Depression as a reference point, Bernanke et al. were determined to limit the contraction in liquidity, support financial institutions and encourage economic activity. Some say too much has been spent, the resulting deficits are worrisome, and the program's a flop, since the economy's still languishing and unemployment remains high.

But the fact that growth is sluggish doesn't mean the stimulus has failed. The relevant question isn't how the economy is doing, but how growth compares against what it would have been without the stimulus. "What if" questions like that are largely unanswerable, but I'm sure we're much better off than we would have been without the government's help.

Home sales are weak, but what would they be if the federal government wasn't directly or indirectly backing 80-85% of all new mortgages and providing \$8,000 tax credits to first-time home buyers? What would 2009 auto sales have been without the "cash for clunkers" program? GDP growth is insubstantial, but what would it be if government spending hadn't risen by double digits?

Although not all the money has been well spent – "a blunt and messy solution" according to William Dudley, president of the New York Federal Reserve (*The New York Times*, January 21) – it seems clear the stimulus program has prevented a much more dire outcome. Regardless, the economy's response is tepid, and I wonder whether the slow growth reflects negative underlying secular trends. This makes me tend toward an expectation that the recovery will be lackluster, and that it will take years before we get back to anything approaching the vibrancy of the period preceding the crisis.

I fall back on the analogy of a stalled car (the economy) being pulled by a tow truck (government stimulus). The tow truck will want to let the car down one of these days and go on its way. Will the car be able to move on its own? We can only wait and see. I think it's more likely to sputter along than it is to move forward energetically. But at least we don't have to worry any longer about the analogy of fifteen months ago: an airplane whose engine has flamed out. A powerless plane in mid-flight presents a far more troubling image than a stalled car.

The Role of Interest Rates

Interest rate reduction has played an extremely important part in the government's efforts to end the crisis and bring the economy back to life.

- By reducing short-term interest rates (in this case to near-zero), the government makes it more attractive to spend and invest, stimulating the economy. This is the most direct effect.

- Lower rates also provide a direct subsidy to financial institutions, which can borrow cheaply and lend at higher rates. (If a bank can borrow \$100 from the government at 1% and lend it out at 6%, it's as if the government wrote the bank a check for \$5 – but more subtle and perhaps less vexing to Main Street, and with potentially positive multiplier effects.) Given the state of financial institutions in 2008, it's clear this element was essential.
- There's a third, less direct effect. Rock-bottom rates on Treasuries push people to chase high returns by undertaking riskier investments. A year ago, the pensioner living on interest opened his year-end mutual fund statement and saw that the return on his T-bill or money market fund was close to zero. He grabbed the phone and called the company to say, "Get me out of that fund and into the one that's paying 15%" . . . and so became a high yield bond investor.

It's clear from the behavior of the markets that something has been goosing investment performance, since the best gains have been seen in the fundamentally riskiest assets. Part of it is general easing of the excessive risk aversion and fear of a year ago, and part is a justified rebound from too-low prices. But certainly near-zero interest rates have played a major part.

As with most remedies – economic and otherwise – ultra-low interest rates raise questions:

- Will economic recovery continue if rates go to market levels?
- Will financial institutions remain viable without the subsidy of low rates?
- Can the residential real estate market recover without support from cheap mortgages?

But what if rates remain low?

- Will foreigners continue to lend the U.S. the money it needs to cover its deficits?
- Can the dollar hold its value against other currencies if international demand weakens for dollars with which to invest in the low-yielding U.S.?
- Most market participants tend to extrapolate currency movements (rather than project their reversal). So if low rates cause the dollar to weaken, will non-U.S. investors shy further from our currency to avoid continued weakness, exacerbating these issues?

Global considerations call for higher rates, but fighting domestic economic weakness relies on low rates. Resolving this dilemma won't be easy . . . or painless.

The Importance of Consumer Spending

At two-thirds of GDP, consumer spending was the linchpin of U.S. economic growth in the decade-plus leading up to the credit crisis. And the foundation for the rapid growth in that spending was the availability of consumer credit and the willingness to use it.

The innovation and explosion of consumer credit, which I view as having begun in the 1970s, enabled Americans to spend money they didn't have to buy things they couldn't afford. This was compounded in the current decade by vastly lowered credit standards for first mortgages and by radical expansion of what used to be called second mortgages but were re-labeled "home

equity loans.” The final element in the equation was the decline in the savings rate to roughly zero in the last decade. Thus consumers spent all they made and, in many cases, more.

These trends enabled growth in spending to exceed the growth in incomes, adding substantially to the growth in GDP. Few people seemed to understand that increases in home prices weren't inexorable, or that there was anything wrong with incurring debts without a foreseeable way to repay them. Shopping became a national pursuit, and fads like “investment dressing” and “investing in collectibles” made reckless spending seem rational.

This all fell apart when the uptrend in home prices collapsed and consumer credit and home loans became unavailable. Fear suddenly replaced limitless optimism among consumers, shopping became dispensable, and the savings rate rebounded to around 5% – meaning spending suddenly grew slower than incomes (which themselves were contracting). The trend in consumer spending, which had buoyed the economy, now led its decline. Further, businesses saw no reason to expand inventories or factory capacity, transferring the slowdown to the manufacturing sector.

What will happen in the future? Will spending rebound? Or will the swing toward frugality and savings be permanent? I recently read an article which dismissed the latter possibility, saying, “People still want a better life.” **I don't doubt that, but what if that “better life” comes to be defined as having more savings and less debt, rather than a new car or another handbag?**

According to *The Wall Street Journal* of December 17:

. . . businesses ranging from shoemakers to financial services to luxury hotels don't expect American consumers to return to their spendthrift ways anytime soon. They see consumers emerging from the punishing downturn with a new mindset: careful, practical, more socially conscious and embarrassed by flashy shows of wealth.

Prudence dictates that people should have savings. But I hasten to point out that “should” isn't the same as “will.” There's a maxim that “No one ever went broke underestimating the intelligence of the American consumer.” I'd prefer to see consumers save rather than return to over-spending – it's healthier for families and for the economy in the long run, providing reserves in case of emergency and capital for investment. But I won't be shocked if they don't.

The Outlook for Real Estate

Just as happened in homes, commercial real estate saw an explosion of excesses in the years leading up to the crisis. Investors and funds – perhaps pursuing the myth that real estate is a good inflation hedge regardless of the price paid – were aggressive buyers.

Capitalization rates or “cap rates” (the demanded ratio of net operating income to price) fell to 4% and sometimes less, implying price/earnings ratios of 25 or more. Property buyers applied those ratios to peak operating income and financed their purchases with copious amounts of debt.

Right now, most borrowers are avoiding default, sometimes abetted by lenders practicing “pretend and extend.” What they’re pretending is that commercial real estate loans will be repayable upon maturity.

It seems inescapable that over the next few years:

- higher vacancy rates and lower rents will keep net operating income from returning to the peak levels of the last cycle,
- property buyers won’t go back to finding sufficient risk compensation in pre-crisis cap rates, and
- financial institutions aren’t going to lend the same high percentage of property purchase prices as they did 3-4 years ago.

Any one of these factors would make it hard for commercial real estate to again command its pre-crisis prices, or for it to be financeable or refinanceable at those levels. Together, the three elements mean many properties are “upside-down” today. That is, their market value is less than the debt against them.

Will a \$100 million loan secured by an \$80 million building be repaid or refinanced? Unlikely. And since that description covers a great deal of commercial real estate today, many real estate loans will go unpaid at maturity. That implies widespread losses for investors and write-downs for lenders.

Many small and medium-sized banks have too much local real estate and construction loans in their portfolios. They fell for the myth of safety in real estate and forgot about the need for geographic diversification. Thus, in addition to real estate bankruptcies, the next few years may see numerous small bank failures.

State and Local Governments

I’m surprised how little we read today about municipal finances. In addition to regularly spending more than they took in (thanks to the miracle of borrowing), many state and local governments got into the habit of ratcheting up budgets in good times, establishing or expanding irreversible spending programs. Thus, today’s substantial declines in sales, income and property tax revenues can’t be met with corresponding cuts in spending.

So now we have massive deficits in places like New York and California – the result of strong spending at a time of soft income. The situation in the latter, my home state, is further complicated by (a) the ability of voters to enact new spending programs through referendums without having to worry about where the money will come from, (b) the fact that the most famous referendum of them all – Proposition 13 – essentially prevents homes from being reassessed to reflect appreciation and (c) the requirement that the annual budget be approved by two-thirds of the legislators in each house, virtually ruling out any unpleasant medicine. It’s for that reason that California resorted to paying its bills in scrip (a practice since discontinued) and furloughing state employees.

Will states and cities go bankrupt in coming years? What will be the effect on their bondholders, and on the municipal bond market as a whole? How will bankruptcy be reconciled with municipal bond issuers' promises to dedicate their full faith and credit to paying interest and principal (and thus, implicitly, to raise taxes without limitation)? How will the federal government respond? If it opens its coffers to bail out profligate states, what will that say to states that were prudent enough to stay out of trouble? No answers here, but lots of trouble in sight.

Our Dance with China

Here are the facts:

- China has vast resources, human and otherwise.
- It produces goods cheaper than the developed countries.
- China's likely undervalued currency aids its competitiveness as an exporter.
- The U.S. buys more from China than it sells to China.
- That means dollars keep piling up in China.
- The U.S. has to borrow back those dollars to fund its fiscal and trade deficits.
- We'd prefer low interest rates in order to minimize our interest payments, and a weak dollar so we can repay our debts (as if!) in devalued currency.
- China, with its reserves growing, has to invest large amounts of dollars.
- China wants high rates and a strong dollar in order to maximize the value of our future payments to them.
- China would probably like to diversify the investment of its reserves away from the dollar, but (a) it's hard to figure out where to better invest them and (b) doing so would further weaken the dollar, of which China already owns so many.

The great thing about not being an economist is that I don't have a view on how all of this will play out. But I'm sure it implies considerable uncertainty.

Wherefore Jobs?

I wonder what will occupy the millions of Americans dependent until now on "physical" jobs. In the late nineteenth century, agriculture became mechanized and many people left the South to find manufacturing jobs in the Midwest. Then manufacturing was automated over time, and the economy went global, reducing the need for American factory workers. Today, relatively little manufacturing takes place in the high-cost U.S. Increasing percentages of our jobs are now in services, government, healthcare, retailing, intellectual property and information.

In "What Worries Me," I expressed concern about an American economy that manufactures less and less, as well as puzzlement regarding the consequences. Where will jobs come from as the population grows and manufacturing continues to shrink?

In addition to replacing 7.2 million lost jobs [since the recession began in December 2007], the economy needs an additional 100,000 a month to keep up with population growth. If the job market returns to the rapid pace of the 1990s – adding 1.25 million private-sector jobs a year, double the 2001-2007 pace – the U.S. wouldn't get back to a 5% unemployment rate until late 2017, Rutgers University economist Joseph Seneca estimated. (*The Wall Street Journal*, October 5, 2009)

“We'll give each person a diploma and a laptop” seems to resonate from the last presidential campaign, but I don't see that as much of an answer to the problem since (a) not every strong back can be redirected to a desk job, especially given that our system of public education is in crisis, and (b) one of the advantages of an information economy is supposed to be that it needs fewer workers to get business done.

In short, I worry that the growth in jobs in the recovery will be slow, and that unemployment and underemployment will remain stubbornly at higher levels than in the past. That doesn't bode well for either the short-term cyclical recovery or the long-term outlook.

Global Competitiveness

Now that the world is one big market and consumers have their choice of goods from anywhere in it, success in producing and selling is largely a function of cost competitiveness. For years, things like the superiority of American products blunted foreign competition. One of the results was that the American worker enjoyed the highest wages and standard of living in the world. But now China, Korea and other nations have eclipsed much of our manufacturing advantage, allowing them to produce goods that are not just cheaper but at times better.

It stands to reason that today, goods produced with high-priced inputs will not compete successfully. In order for U.S. goods to be competitive, our costs will have to come down, and with them our relative standard of living. Why should any country's workers be able to command a higher standard of living if the goods they produce aren't demonstrably superior?

These trends have already taken effect in “legacy industries” like airlines and autos. For example, one of the main goals of the auto bankruptcies was to limit retirees' lifetime benefits. I think we'll continue to see declining relative costs in the U.S., to the betterment of our competitiveness but the detriment of our workers.

Inflation, Exchange Rates and Interest Rates

The macro question I get most often concerns the outlook for inflation. And as someone who lived through stagflation in the 1970s and paid interest at 22-¾%, I think it's very much worth considering.

The hyperinflation of the '70s was sparked by the Oil Embargo of 1973. Labor contracts and benefit plans containing cost-of-living adjustments built on that to create a cost-plus cycle in

which inflation lifted wages, contributing further to inflation, and so forth. Rising prices frightened people into demand-pull inflation by convincing them to stock up on goods to avoid higher prices later. And people borrowed to invest in assets like land out of a belief that no matter what interest rate they paid to finance their purchase, the asset's price would increase at a faster rate (the epitome of inflationary thinking).

No one knew how to solve the problem. I used to go to hear “Dr. Gloom” and “Dr. Doom” (economists Al Wojnilower of First Boston and Henry Kaufman of Salomon Brothers) compete to be more depressing. They talked about how hard it would be to get inflation down to “an acceptable level.” One day, I heard someone ask for the definition of “an acceptable level.” He was told “one-third less than whatever it is at the time.”

Finally, however, in the early 1980s Paul Volcker and the Fed implemented the painful solution of significantly higher interest rates, inflation subsided, and the stock market took off. Over the next 25 years, rising inflation and interest rates were forgotten as possible sources of risk.

Today, labor in the U.S. lacks the power to demand strong wage increases or COLAs. Further, the sluggish macro picture argues against demand-pull. Strong inflation is usually associated with higher levels of prosperity and stronger demand for goods than I foresee. Finally, inflation often presupposes pricing power on the part of manufacturers, which I also don't see.

Those are the factors that argue against an increase in inflation. However, because of other forces – primarily financial and international – it could take increasing numbers of dollars to buy a given quantity of the imported goods on which we've become so dependent (a.k.a. inflation).

- As I mentioned earlier, debtors want there to be inflation so they can repay their debts with currency that's worth less. To accomplish this, debtor nations have the ability to debase their currencies by printing more of it. For the clearest example, see “The Limits to Negativism” (October 15, 2008) on the subject of the Weimar Republic. Post-World War I Germany was assessed war reparations it couldn't afford, so it simply over-stamped its 1,000 mark notes “1 million marks.” All of a sudden it had created enough marks to pay its debt to the world . . . and destroyed the purchasing power of its currency.
- A dollar weakened by reduced demand for it (e.g., as a vehicle for the investment of China's reserves) would, likewise, equate to more dollars per item bought from abroad.
- Finally, “stores of value” like gold hold value only because people agree they will. The same goes for currencies. Profligate spending, runaway deficits and declining world position could reduce the role of the dollar as a reserve currency, again cutting into its purchasing power.

I'm certainly in no position to predict a decline in the purchasing power of the dollar (that is, a bout of strong inflation). However, I do think it's very much worth worrying about.

When Paul Volcker left the Fed in 1987, he was asked at his first public appearance, “Will interest rates go up or down?” He answered presciently: “Yes.” Of course, his answer is still the right one. **But from today's levels, I think rates are more likely to go up than down (there's so little room for the latter).**

Reduced faith in the dollar means it would take higher interest rates to attract non-U.S. buyers to dollar investments. And, even domestically, (a) one of these days the government will stop holding rates down and (b) higher inflation would require rates to rise to compensate for the fact that the dollars with which debts are repaid will buy less. For all these reasons, I think investors must consider the prospect of higher inflation, dollar weakness and higher interest rates.

What to do about them? The list of possibilities is long:

- Buy TIPS.
- Buy floating rate debt.
- Buy gold (but only at the “right” price, and what’s that?)
- Buy real assets, such as commodities, oil and real estate (ditto).
- Buy foreign currencies.
- Make investments denominated in foreign currencies.
- Buy the securities of companies that will be able to pass on increased costs.
- Buy the securities of companies that own commodities, or that own assets denominated in foreign currencies.
- Buy the securities of companies that earn their profits outside the U.S.
- Hold cash (to invest once interest rates have risen).
- Sell long-term bonds (and possibly go short).

These are the actions that can profit from – or that provide the flexibility to adjust to – increased inflation, a decline in the dollar and increased interest rates, all of which are interconnected. The most important one is the last one: long-term bonds could suffer worst in an inflationary, higher-rate environment, especially given today’s low starting yields.

One final point: When I provide this answer to the frequent question about inflation, I ask people whether they agree. Usually they do. Then I ask how much of their portfolio they’re willing to devote to protecting against these macro forces. If their answer is 5%, 10% or 15%, I point out that that’s pretty close to doing nothing. The question is whether you’re willing to devote at least 30-40%. Few people are.

But that’s the thing: It’s easy to say, “I’m worried about inflation.” It’s something very different to say, “I’m worried enough about inflation to do something meaningful about it.” Let me know when you decide how much you’re willing to devote.

The Environment for Business

Moving all the way out on the timescale, I’d like to say a few words about some of my biggest-picture concerns.

I worry about long-term problems that are being left untreated, such as our massive deficits and our under-funded Social Security, Medicare and education systems.

I worry about the long-term impact of government involvement in business decisions: telling companies what they should pay top employees and setting minimums for the percentage of premium revenue that a health insurer should pay out in benefits, for example. The Obama administration has the smallest percentage of Cabinet secretaries with backgrounds in the private sector of any president since Teddy Roosevelt, according to the November 24 issue of *Forbes*. People in the executive and legislative branches with no experience in business are telling business how to operate.

Lastly, I worry about the rising tide of populism and anti-business sentiment. I've never seen negative attitudes like those toward financial institutions today. Administration members with Wall Street backgrounds are regarded with suspicion; high incomes are considered wrongful; and banks and investment banks are seen as victimizing America, not rendering it prosperous. Schadenfreude is in the ascendancy, with people wishing ill for successful bankers. Politicians pander by throwing gasoline on the fire. With an election coming up, I expect candidates to compete to see who can be tougher on Wall Street.

I mentioned in "What Worries Me" that decades ago, when a socialist-leaning labor movement was ascendant in the U.K., I came across a good explanation for the success of U.S. business:

When the worker in England sees the boss drive out of the factory in his Rolls Royce, he says, "I'd like to put a bomb under that car." When the American worker sees the boss drive out in his Cadillac, he says "I'd like to own a car like that someday."

More recently, in 2005, Thomas Friedman compared old and new economies as follows:

French voters are trying to preserve a 35-hour work week in a world where Indian engineers are ready to work a 35-hour day. Good luck. . . .

Voters in "old Europe" – France, Germany, the Netherlands and Italy – seem to be saying to their leaders: stop the world, we want to get off; while voters in India have been telling their leaders: stop the world and build us a stepstool, we want to get on. . . .

A few weeks ago Franz Müntefering, [then] chairman of Germany's Social Democratic Party, compared private equity firms – which buy up failing businesses, downsize them and then sell them – to a "swarm of locusts."

The fact that a top German politician has resorted to attacking capitalism to win votes tells you just how explosive the next decade in Western Europe could be, as some of these aging, inflexible economies – which have grown used to six-week vacations and unemployment insurance that is almost as good as having a job – become more intimately integrated with Eastern Europe, India and China in a flattening world. ("A Race to the Top," *The New York Times*, June 3, 2005 – emphasis added)

Capitalism, free enterprise, pro-business policies, adaptability, work ethic and profit – these are the concepts that have generated most of the material progress in this world.

They were behind much of America's relative gains in the twentieth century, just as they now hold great promise for China, India and Brazil. Compare the growth records and prospects of countries that exhibit them against countries that don't. **Which kind of country will the U.S. of the future be?**

Today people seem to think of companies like Goldman Sachs and JPMorgan Chase as enemies, not friends – companies to be rooted against, not for (and there are non-financial examples as well). I'd like those people to tell me what engine of progress will propel America ahead in the twenty-first century. It's not going to be the barbershops and fast-food outlets. It has to be big, world-leading businesses, working on behalf of their investor-owners.

We're a big country, and we'd better pull for big business – not against it. We'd better remember that “what's good for business is good for America.” If we don't, and if big business isn't allowed to thrive, wondering about the shape of the coming recovery or the outlook for security prices in 2010 will amount to nothing more than “rearranging the deck chairs on the Titanic.”

Investment performance in a single year should matter principally to people who're going to liquidate their portfolios at the end of that year. Most of us expect our holding periods to go on well beyond 2010. So we'd better hope for a salutary long-term environment in which to hold.

* * *

I'm not writing to be negative or to depress readers. And as I said earlier, I don't claim to be presenting the whole picture. Nevertheless, I hope I'm providing a service.

The question isn't whether there'll be a recovery, but what type. In fact, a recovery is doubtless underway as I write. But for the reasons enumerated above, I think it'll turn out to be anemic and possibly marked by fits and starts, not a powerful “V.”

- The recovery will face headwinds in the form of declining manufacturing and weak job creation.
- Slow job growth, sluggish incomes, spending that grows slower than incomes, and scarcer consumer credit likely will combine to limit the consumer's ability to energize the economy.
- Removing the props of elevated government spending, debt guarantees and artificially low interest rates will limit its vibrancy.
- We'll continue to face challenges in terms of real estate losses, bank write-downs and fiscal and trade deficits.

On the other hand, near-term economic statistics will benefit from the following:

- easy comparisons against depressed prior levels,
- the rebuilding of inventories and refilling of pipelines to meet recovering demand, and

- big companies' large cash holdings, delevered balance sheets and eagerness to respond to increased orders.

When people ask me when we'll get back to normal, I ask what they mean by normal. If they mean an environment like 1992-2007, I tell them those were unusually good times, not what the "normal" of the future is going to look like.

The fifteen (or 25) years just prior to the credit crisis were marked by strong, consumer-led growth; rapidly increasing use of credit; American leadership in media, software, technology and financial products; and powerful bullishness and expansiveness. I doubt the years just ahead will be equally positive.

My goal in this memo isn't to express a forecast. I know no forecast – and certainly not mine – is likely to be correct. What I do want to do is caution that the considerable risks I see may be less than fully appreciated by those setting asset prices today. The greatest market risks lie in failure of the macro economy to live up to the expectations embodied in today's prices. **Please tell me if you think I'm wrong in letting the factors described above push me toward caution. In fact, I'd love it if you told me my worries are unfounded, and that our economic and business future will see a complete return to good times.**

Most people view the future as likely to repeat past patterns, which it may or may not do. They tend to think of the future in terms of a single scenario, whereas it really consists of a wide range of possibilities. (Remember Elroy Dimson's trenchant observation that "risk means more things can happen than will happen.") And to the extent they do consider a variety of possibilities, few people include ones that haven't been part of recent experience.

The uncertainties discussed above tell me today's distribution of possibilities has a substantial left-hand (i.e., negative) tail, probably greater than at most times in the past. The proper response should be to discount asset prices, allowing a substantial margin for error. Forecasts should be conservative, yield spreads should incorporate ample risk premiums, valuation parameters should be below the long-term norms, and investor behavior should be prudent.

And yet, the powerful rally of 2009 has more than offset the decline of 2008 in many asset classes. To the extent that the resultant valuations incorporate optimism, I would argue for caution today. A lot of "easy money" was made last year; in retrospect, all you had to do was have access to capital and the guts required to invest it at the absurd low prices of late 2008/early 2009 and hold on during the wild recovery. **Of course, those things were far from easy at the time.**

The profits ahead won't be easy money. They'll require careful selection, appropriately high risk consciousness, insistence on margin for error, and cooperation from the forces that determine outcomes (such as luck). With most assets valued about fairly today, caution, discernment and discipline – not much needed in 2009 – have replaced guts as the essential elements in profitable investing.

January 22, 2010

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Memo to: Oaktree Clients
From: Howard Marks
Re: I'd Rather Be Wrong

Just a few weeks ago, I published “Tell Me I’m Wrong,” my latest list of things in the investment environment that I find worth worrying about. I’m going to devote a few pages here – I promise this’ll be the shortest memo in years – to a point I touched on in “What Worries Me” (August 28, 2008) but omitted from the more recent piece.

This memo will be about one of the inarguably most depressing topics of our time: the seeming inability of governments and politicians to solve – or even tackle – the financial problems we face. Here’s the situation in Washington:

- Many of our most sweeping financial problems, such as deficits, national debt, healthcare costs, Social Security and Medicare, are long-term problems.
- It’s important that we tackle them early, since limiting their further growth can reduce the eventual cost and difficulty of fixing them.
- But the process of solving them will be unpleasant in the short term, entailing bad-tasting medicine, while the benefits will only be seen in the long term, when today’s politicians will have left the stage.
- Finally, most politicians’ main concern seems to be getting themselves and other members of their party elected. Voting for short-term pain in order to solve long-term problems is generally viewed as the wrong way to go about that.

This memo is inspired by two excellent newspaper articles that appeared within the last month: “Party Gridlock Feeds New Fear of a Debt Crisis,” by Jackie Calmes (*The New York Times*, February 17)^{*} and “Perils of the California Model” by David Wessel (*The Wall Street Journal*, March 4).[†] Indicating their importance, *The Times* piece ran in the upper right-hand corner of the front page, always the place for the top story of the day, and the *Journal* story was carried on page A2. I’ve included links below in the hope they’ll increase your likelihood of reading them. As Calmes wrote in *The Times* (in both cases below, emphasis added):

After decades of warnings that budget profligacy, escalating health care costs and an aging population would lead to a day of fiscal reckoning, economists and the nation’s foreign creditors say that moment is approaching faster than expected, hastened by a deep recession that cost trillions of dollars in foregone tax revenues and higher spending for safety-net programs.

Yet rarely has the political system seemed more polarized and less able to solve big problems that involve trust, tough choices and little or no short-

^{*} <http://www.nytimes.com/2010/02/17/business/economy/17gridlock.html>

[†] <http://online.wsj.com/article/SB20001424052748704541304575099371249822654.html>

term gain. The main urgency for both parties seems to be about pinning blame on the other, before November's elections, for budget deficits now averaging \$1 trillion a year, the largest since World War II relative to the size of the economy.

Two weeks later, Wessel put it this way in *The Journal*:

The stalemate over health-care legislation, despite widespread acknowledgment that the status quo is unsustainable, underscores the inability of the political system to cope with complex, long-term fiscal issues. . . .

Today, the deficits projected are bigger than ever, baby boomers are beginning to retire, health-care costs keep rising and, surely, we're closer to the day when Asian governments grow reluctant to lend ever-greater sums to the U.S. Treasury at low interest rates.

The Congressional Budget Office projects current policies would take the deficit from today's 10% of gross domestic product to over 20% by 2020 and over 40% by 2080. **Yet today's politics appear more toxic, and the ranks of congressional leaders with the skill and desire to fashion compromises instead of talking points are depleted.**

Here we have remarkably similar themes voiced in what some would call "a Democrat newspaper" and in a stalwart of the pro-business Republican establishment. Both articles complain that the current trends in politics reduce the likelihood that major problems will be tackled and solved . . . a rare example of agreement across the aisle.

That brings me to the subject of one of today's greatest stumbling blocks, the absence of that elusive ideal: bipartisanship. Let's discuss this issue in principle. It's likely that the "ins" always think the fact that voters gave them control means they should mostly get their way, and that "bipartisanship" consists of the "outs" going along with them. The outs, on the other hand, don't take the election results to mean the minority has no rights, and they feel perfectly within their rights to use Congress's rules and processes to fight for their point of view (which, on us-versus-them issues, equates to thwarting the efforts of the ins).

The Times article points out ironically that when control of government is divided between the two parties, they both feel some responsibility for solving problems, while today, with full control seemingly in the hands of the Democrats, the Republicans are free to view their only role as dissenting and obstructing. And as the party in control, the Democrats evidently feel no obligation to yield on their positions.

Frankly, I wouldn't be so unhappy if I were sure today's battles were being fought over principles. What worries me most is the appearance that, instead, they're being fought for personal and political advantage and to win elections.

Today I think few legislators from either party will vote for anything that would let members of the other party claim to have accomplished something. That may be an exaggeration, but I think it's more true than false. And I think that's behind the recent decisions by a number of senior legislators not to run for re-election. I've had the privilege of getting to know Byron

Dorgan, the senator from North Dakota, and I have no trouble believing that was behind his decision. We've spoken about his frustration with the contentious environment in Washington. More recently, Evan Bayh of Indiana also said he wouldn't seek another term in the Senate because it's impossible to get anything done in dysfunctional Washington. Here's how he put it in a February 21 Op-Ed piece in *The Times*:

There are many causes for the dysfunction: strident partisanship, unyielding ideology, a corrosive system of campaign financing, gerrymandering of House districts, endless filibusters, holds on executive appointees in the Senate, dwindling social interaction between senators of opposing parties and a caucus system that promotes party unity at the expense of bipartisan consensus.

Today's positions seem unusually unyielding. The Republicans' conservative base demands adherence to the no-tax pledge, while liberal Democrats demand that their representatives prevent cuts in spending for domestic programs. These hardened (and polar) positions greatly narrow the possible grounds for problem-solving.

When the seller says "I won't accept any price below \$20" and the buyer says "I'll never pay more than \$18," no deal can be struck, whereas in more flexible times they might meet at \$19. Maybe one party or the other (or both) is right and should stand on principle. But when we need them to find common ground on which to solve critical problems, refusal to reach agreement isn't to our advantage.

- Everyone wants to see the deficit narrowed, but today's circumstances seem to prohibit both expenditure reduction and revenue increases. Everything else is on the table (as the kids say, lol).
- We know Social Security has to be fixed in order to prevent its inevitable insolvency, since there are fewer and fewer working people paying into the system per retiree. However, some people find it unacceptable to raise tax rates or the limit on taxed income, and others resist reducing or delaying benefits. Thus no one in Washington seems to prefer tackling the problem over sweeping it under the rug (Congress's version of "extend and pretend").
- On the state and local level, there's massive underfunding of pensions, but few officials consider it possible to either reduce benefits or increase employee/employer contributions. Thus only two possibilities remain: ignore the problem or hide it by increasing the assumed return on assets (from today's already-challenging levels of 8% or more).

In the old days, the Lyndon Johnsons in Congress would sit down for a drink with the other side, swap a "yes" vote on this for something else, and get things done. For any of a million reasons, this seems impossible today. Calmes quotes G. William Hoagland, a former fiscal policy adviser to Senate Republicans, as follows:

I used to think it would take a global fiscal crisis to get both parties to the table, but we just had one. These days I wonder if this country is even governable.

I hasten to state that I don't view this as a question of one side being right and the other wrong. At this moment, with the Democrats in control of the White House and both houses of Congress, the Republican minority seems to be hell-bent on frustrating the Democrats' plans (and capable of doing so). But my criticism isn't reserved for today's minority party. I have absolutely no doubt that unless something changes, the next time the Republicans are in power, the roles will be reversed and the Democrats will be the obstructionists.

You can think the things President Obama wants to do are either right or wrong, but you can't deny the fact that, even with majorities in both houses of Congress, he can't do them. This truly is gridlock.

Some people think gridlock is a good thing. They think either (a) government should do less rather than more or (b) government is incapable of doing anything right (or both). In my opinion, you have to hold attitudes like those in order to be optimistic about the situation in Washington. However, there are some things only government can do. **Even the founding fathers, as leery of government as some were, created one. Many of today's problems are government-created, so government will have to solve them.**

I believe most Americans want to see the problems solved. Of course, they disagree on how best to do so. But our leaders should work together to find solutions and explain to the voters why compromise is necessary. **That's an important part of leadership . . . perhaps more important than simply resisting the other party's suggestions.**

The people in Washington may be of good will; certainly most of those I've met seem to be. They probably believe the positions they hold are the right ones. But they have to let go of their obsessions with re-election, personal preferences and politics as a contact sport. We need them to take up and solve the important problems, and I see no movement in that direction.

In fact, I see additions to the arsenal of delay and frustration. When I was a boy, filibusters – weeks-long orations – were employed on rare occasions to hamper legislative action. Now filibusters can be virtual, meaning no talking is required; you just say, "I filibuster." It takes 60 votes in the Senate to bring something to the floor over an objection. Thus, with filibusters more frequent, 60 votes have replaced 51 as the threshold for forward motion. (Since I'm from California, where it takes two-thirds of the legislature to approve a budget, I can assure you that supermajorities don't result in better decisions, just inaction.)

When I see tactics like this in use – and this brand of partisan warfare, where it's all about winning and losing – I tend to agree with Will Rogers: **"The more you observe politics, the more you've got to admit that each party is worse than the other."**

I don't think any elected official who puts re-election above all else can do the right thing when it comes to hard choices. If the decisions were easy and the remedies palatable to the electorate, they would have been implemented by now. Instead, the answers to today's problems will be painful and displease some voters (if not all). Here's how Wessel puts it:

Imagine this plausible scenario: Public confidence in government continues to decline. Unemployment remains high. Americans demand more government services, more benefits and lower taxes.

Politicians, seeking re-election, go along. Exhibit A: John McCain, the Arizona Republican who called for cutting Medicare as a presidential candidate last year and now, fighting for reelection to the Senate, proposes to erect new parliamentary obstacles to Medicare cuts.

In this scenario, even deficit-fearing politicians avoid taking on the long-term deficit. [Syracuse University's Leonard Burman] imagines a White House political adviser saying: "Mr. President, if you raise taxes or cut popular programs, you or your party will be defeated in the polls and the bad guys will take over. The bad guys do not share your priorities and they do not care about the deficit. Therefore, you cannot effectively deal with the deficit."

Unusually for me, I have a remedy in mind. **Let's tell our elected officials we want solutions, not warfare; compromise, not intransigence. And let's try to elect moderates in both parties, not extremists.** I don't know if it'll work, but I don't see many alternatives.

I'll move toward my conclusion with a quote (per *The Times*) from former Republican Senate leader Alan Simpson, who has been selected to co-chair the commission on the deficit:

There isn't a single sitting member of Congress – not one – that doesn't know exactly where we're headed. And to use the politics of fear and division and hate on each other – **we are at a point right now where it doesn't make a damn whether you're a Democrat or a Republican if you've forgotten you're an American.** (emphasis added)

And where is it that every single member knows we're headed? At a reception I was fortunate to attend earlier this month, Hank Paulson described the situation roughly as follows (I paraphrase):

At the family level, we try very hard to leave the next generation better off than we are. But at the national level, we're living in the present and ignoring massive problems with which the next generation will be saddled.

Wessel ends with a quote from President Ronald Reagan, and I'll go along with him. In 1982, Reagan had to sell a package of spending cuts and tax increases. In other words, there was something for everyone to dislike. But Reagan didn't shrink from such things. Here's what he said:

Do we tell . . . Americans to give up hope, that their ship of state lies dead in the water because those entrusted with manning that ship can't agree on which sail to raise? We're within sight of the safe port of economic recovery. Do we make port or go aground on the shoals of selfishness, partisanship, and just plain bullheadedness?

March 17, 2010

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Memo to: Oaktree Clients

From: Howard Marks

Re: Warning Flags

For about a year, I've been sharing my realization that there are two main risks in the investment world: the risk of losing money and the risk of missing opportunity. You can completely avoid one or the other, or you can compromise between the two, but you can't eliminate both. One of the prominent features of investor psychology is that few people are able to (a) always balance the two risks or (b) emphasize the right one at the right time. Rather, at the extremes they usually obsess about the wrong one . . . and in so doing make the other the one deserving attention.

During bull markets, when asset prices are elevated, there's great risk of losing money. And in bear markets, when everything's at rock bottom, the real risk consists of missing opportunity. Everyone knows these things. But bull markets develop for the simple reason that most people are buying – ignoring the risk of loss in order to keep from missing opportunity – just when elevated prices imply losses later. Likewise, markets reach their lows because most people are selling, trying to avoid further losses and ignoring the bargains that are everywhere.

The Never-Ending Cycle

Why do people buy when they should sell, and sell when they should buy? The answer's simple: emotion takes over. Price increases excite investors and encourage them to buy, and price declines scare them into selling.

When the economy and markets boom, people tend to assume more of the same is in the offing. They find little to worry about, other than the possibility that others will make more money than they will. Fear of loss recedes, and fear of opportunity costs takes over. Thus risk aversion evaporates and risk tolerance rises.

Risk aversion is absolutely essential in order for markets to function properly.

When sufficient risk aversion is present, people shrink from riskier investments and prefer safer ones. Thus riskier investments have to appear to offer higher returns in order to attract capital. That's as it should be.

But when people get excited about the prospect of easy money – even if from assets or investment strategies that have become far too popular, turning into overpriced manias – they frequently drop their risk aversion and adopt risk tolerance instead. Thus they swarm into the investment *du jour* without concern for its elevated price and risk. This behavior should constitute an important warning flag for prudent investors.

In the same way that expanded risk tolerance accompanies appreciated asset prices and contributes to the risk of loss, so does risk aversion tend to rise in times of depressed prices, increasing the risk of missed opportunity. When people refuse to buy assets regardless of their low prices, they miss out on the best, lowest-risk returns of the cycle.

Recent History – on the Upside

Just as the recent market cycle was extreme, so was the swing in attitudes regarding the “twin risks.” And thus so are the resultant learning opportunities.

Risk aversion was clearly inadequate in the years just before the onset of the crisis in mid-2007. In fact, I consider this the main cause of the crisis. (Last year, *DealBook*, the online business publication of *The New York Times*, asked me to write about what I thought had been behind the crisis. My article, entitled “Too Much Trust, Too Little Worry,” was published on October 5, 2009. It offers more on this subject should you want it.) Here’s the background regarding the early part of this decade:

Interest rates kept low by the Fed combined with the first three-year decline of stocks since the Depression to reduce interest in traditional investments. As a result, investors shifted their focus to alternative and innovative investments such as buyouts, infrastructure, real estate, hedge funds and structured mortgage vehicles. In the low-return climate of the time, much of the appeal of these asset classes came from the fact that they promised higher returns thanks to their use of leverage, whether through borrowing, tranching or derivatives.

Given the high promised returns, investors forgot about (or chose to ignore) the ability of leverage to magnify losses as well as gains. Contributing to investors’ rosy view of leverage’s likely impact was their belief that risk had been banished by (a) the efficacy of the Fed and its “Greenspan put,” (b) the combination of securitization, disintermediation, tranching, decoupling and financial engineering, and (c) the “wall of liquidity” coming toward us from China and the oil producing nations.

For these reasons, few market participants were afraid of losing money. Most just worried about missing opportunity. The unattractive outlook for stocks and bonds meant investors would have to be aggressive and innovative if they were going to earn significant returns in the low-return environment. Thus risk aversion (a) was unnecessary and (b) would be counter-productive. “You’d better invest in this new financial product,” people were told. “If you don’t, you’ll miss out. And if you don’t and your competitor does – and it works – you’ll look out-of-step and fall behind.” When contemplating a virtuous circle without end, investors usually think of only one word: “buy.”

This describes the process through which fear of missed opportunity can overcome skepticism and prudence. And in this period, that’s what happened. No one worried

about losing money. Fear of missed opportunity drove most investors, and Citibank's Chuck Prince famously said, ". . . as long as the music is playing, you've got to get up and dance. We're still dancing." Although he worried about a possible decline in liquidity, he worried more about falling behind in the manic race to provide capital.

Recent History – on the Downside

The events from mid-2007 through late 2008 or early 2009 demonstrate the reverse in operation. The upward trend in home prices ground to a halt and subprime mortgages began to default in large numbers. Leveraged vehicles melted down. Credit became unavailable, and financial institutions needed rescuing. Recession caused spending to contract, and corporate profits declined. Bear Stearns, Merrill Lynch, AIG, Fannie Mae, Freddie Mac, Wachovia and Washington Mutual all required rescues. Bank capital, commercial paper and money market funds needed federal guarantees. After the bankruptcy of Lehman Brothers, people began to ponder the collapse of the financial system. As often happens in scary times, "possible" morphed into "probable," or at least something very much worth worrying about.

Now a vicious circle replaced the virtuous one of just a few months earlier. And with its arrival, the fear of losing money replaced the fear of missing opportunity. As I've said before, I imagine most investors' cry was, "I don't care if I ever make a penny in the market again; I just don't want to lose any more. Get me out!"

For most investors, no assumption was too negative to be true, and no potential return made the risk of loss worth bearing. High yield bonds at 19% yields. First lien leveraged loans at 18%. Investment grade bonds at 11%. None of these was sufficient to induce risk-taking.

As I wrote in "The Limits to Negativism" (October 15, 2008), "Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive." By the fourth quarter of 2008, risk aversion ruled and risk tolerance had disappeared. A skeptical view toward excessive pessimism was called for at a time of unprecedented low asset prices, but few people could muster it. The credit markets offered the highest returns in their history, but fear of losing money kept most investors from seizing the opportunity.

In the middle of this decade we saw a manic period in which losses were unimaginable. The resultant shortages of risk aversion and skepticism caused investors to buy at highs and assume unprecedented risks in order to avoid missing opportunity. This was followed – as usual – by a collapse in which no negative event could be ruled out and no return was high enough to induce buying, all because investors wanted nothing other than to avoid losing money.

This cycle produced a treacherous, low-return period in which it was very hard to find investments promising good returns earned with safety, and then a period of collapse in which there were bargains everywhere but few investors possessed the requisite "dry

powder” and intestinal fortitude with which to buy. That’s the background. Where do we stand today?

Signs of the Times

Optimism, adventurousness and unworried behavior characterized the pre-crisis period, and investor behavior reflected those attitudes. In my memo “It’s All Good” (July 16, 2007), just before the onset of the crisis, I mentioned some of the warning signs in the credit markets:

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. . . .

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 inspiration for today’s memo came as my pile of clippings began to swell with indications that pre-crisis behavior is coming back. Here are excerpts from a few, with emphasis added in each case:

On covenant-lite loans –

Are debt investors just stupid? That might help explain why they’re buying covenant-lite loans again. These deals, which carry few restrictions on borrowers, became a standard bearer for easy money. They may have helped some companies limp through the downturn – but they’ve left lenders saddled with lots of risk and little return.

It’s easy to see why companies like covenant-lite loans. . . . But for owners of the debt, the attraction is far less clear beyond the familiar short-term reach for yield. . . .

Lyondell Chemical is paying [Libor plus 400 basis points] on its recent \$500 million covenant-lite deal. And the energy refiner will emerge from bankruptcy with a much slimmer debt load than before it filed for Chapter 11.

Lyondell's terms are better than 2007's crop of covenant-lite loans, to be sure, but lenders still are essentially relinquishing their right to force companies into paying them more money, or exiting the loan entirely, should their creditworthiness tumble.

So why are lenders doing it again? Lyondell Chemical's answer: investor demand for higher yielding assets. This is a familiar mantra while official interest rates remain low. **But lenders should be mindful of loosening standards or risk finding themselves once again on the short end of the stick.** ("Don't call it a comeback," *breakingviews*, April 5)

On payment-in-kind loans and flexibility –

Clint Eastwood's Dirty Harry character famously held a gun to a suspect and asked: "Do you feel lucky?" Investors in credit markets seem to be saying yes, if Cerberus' refinancing of Freedom Group, maker of Remington firearms, is any indication.

A deflating gun bubble backfired on the private equity firm's plans last year for an initial public offering of Freedom. Now trigger-happy credit investors are taking off their safeties and letting Cerberus unload some of its stake.

The \$225 million of notes are useful ammo for Cerberus. They allow Freedom to either pay the interest in cash or half in cash and half in additional notes at the company's discretion. The financing allows Cerberus to get cash back on its investment today by buying back preferred stock held by the private equity group ahead of an eventual IPO. . . .

The buyers of these notes, though, are taking their chances. Freedom doesn't look overleveraged according to its historic cash flow – the company's debt level is about three times "adjusted EBITDA" for 2009. But sales of rival gun-makers are continuing to fall. . . .

Moreover, these sorts of notes are notoriously difficult to price. The investor has to figure out the risk of the company encountering cash flow problems, whether the firm will actually pull the toggle trigger, and how much the PIK feature may reduce their potential recovery in the event of default. Indeed, many investors took drubbings on similar notes issued at

the top of the credit boom. **Caution is warranted when investors remove their trigger locks.** (“Do you feel lucky?” *breakingviews*, March 31)

On initial public offerings –

It is springtime for IPOs. . . . KKR and Bain, two of the most aggressive private-equity firms during the buyout boom, are now as aggressively looking to cash out. They are leading what is expected to be a season of IPOs as long as the markets continue to stabilize or climb. The IPOs would allow the firms to partially cash out their stakes and return money to investors. They also could use the proceeds to pay down the sizable debt used to finance the takeovers. (“Bain, KKR to Push New Crop of IPOs,” *The Wall Street Journal*, April 9)

On leveraged loans –

Even as worries escalate about the ability of highly rated countries to fund themselves, there is a buzz at the other end of the credit spectrum.

Leveraged loans, a source of funding for private-equity acquisitions, are drawing investor interest again after a long period in the doldrums.

In the U.S., there are signs of life in the collateralized-loan-obligation market, with the year’s first deal not only refinancing an existing CLO but bringing in new money, too. In Europe, HarbourVest Partners is launching a listed fund to invest in mid-market leveraged loans. Leveraged-finance bankers are more bullish, and new loans have started to flow. . . .

There are wider implications, too: **Cash moving into the loan market represents a greater willingness to hold more illiquid assets, an important development. . . .** (“A Pulse Finally Returns to the Leveraged-Loan Market,” *The Wall Street Journal*, April 12)

© On dividend recaps –

Blackstone Group LP and other private-equity firms are accelerating sales of junk bonds and leveraged loans to pay themselves dividends in a sign the market for the riskiest debt may be overheating.

Apria Healthcare Group Inc., owned by Blackstone, is seeking consent from bondholders to sell notes to issue a dividend, following at least six similar offerings this year, according to data compiled by Bloomberg.

Including loans, companies have raised \$10.8 billion in debt to fund payouts this year, compared with \$1 billion in all of 2009 and \$1.3 billion in the prior 12 months, according to Standard & Poor's LCD.

Private-equity firms are taking advantage of record high-yield, high-risk bond sales and a rally in loans to extract cash from companies they own, awaiting a rebound in leveraged buyouts and initial public offerings. So-called dividend deals, which permeated debt markets in 2006 and 2007 before the credit seizure, may signal investors are becoming too complacent, said William Quinn, chairman of American Beacon Advisors Inc.

“You start to be concerned that you’re increasing leverage, which was one of the things that created these problems in 2008,” said Quinn, who helps oversee \$45 billion for the fund manager in Fort Worth, Texas. **“I understand why private-equity firms do it, but I would be concerned.”** (“Dividend Deals Rebound as Blackstone Seeks Cash,” *Bloomberg*, April 16)

Companies may increase borrowing to pay shareholder dividends in a record year for junk bonds, Standard & Poor's said. . . .

“We are starting to see the proceeds of high-yield issues being channeled to shareholders as dividends, something that is less-welcome from a credit perspective, reminiscent of the leveraged finance market back in 2007,” analysts led by Taron Wade wrote

Companies owned by LBO firms in 2007 issued a record 6.1 billion euros of loans in the first half to pay dividends to shareholders, data compiled by Fitch Ratings show.

Private-equity firms “essentially decreased the risk of their portfolio equity investments, boosting their near-term equity returns at the expense of the credit quality of the companies themselves,” according to S&P. (“Junk Bond Issuers Increase Dividend Deals, S&P Says,” *Bloomberg*, April 20)

On collateralized loan obligations –

Citigroup is set to launch its second leveraged loan structured products transaction this year, this time for a large private equity client, as **debt managers and bankers look to revitalise the markets which drove the buyout boom. . . .**

If the transaction goes ahead soon, it will be only the second CLO to be sold since the beginning of 2009. Last month Citigroup structured a \$525m CLO managed by US fund manager Fraser Sullivan Investment Management. . . .

Leveraged finance bankers are hopeful the CLO market can take off again as it would provide greater availability of finance for leveraged loans, the engine of the private equity industry. The market for CLOs ground to a halt after the collapse of Lehman Brothers pushed credit markets into freefall. Even the most actively traded leveraged loans lost as much as a third of their face value in the depths of the crisis. (“Citigroup markets second CLO,” *Financial News*, April 19)

On buyouts –

Private equity firms bear some resemblance to children at a fairground: they jump on a ride as dealmaking gathers pace, whizzing faster and faster, before jumping off as the cycle slows down. As the ride starts to gather pace again, buyout firms are back, with some eyeing the biggest rides. (Emphasis in the original)

Mega-deals – transactions over \$10 bn that were favoured in the boom years of 2006-2008 but have been crimped by the lack of debt – are making a comeback. Last week, Blackstone Group and other investors were in talks to acquire financial data processing company Fidelity National Information Services, according to The Wall Street Journal.

The acquisition of Fidelity, which has a market capitalisation approaching \$10 bn and about \$3 bn in debt, would be the largest leveraged buyout since the credit crisis struck. . . .

Bankers and buyout executives said the resurrection of large buyouts was being driven by a booming high-yield bond market. With low interest rates in Europe and the US, investors are more willing to take the risk of weaker credits because it allows them to secure yields unavailable in other forms of lending. (“Are dealmakers ready for another white-knuckle ride?” *Financial News*, May 10)

On investor psychology –

Irrational equanimity is back. Not only are developed market stocks back to pre-Lehman levels, but investors’ comfort levels are in a zone not seen since the eve of the credit crisis in early 2007. Apart from US stock indices, this shows up in the price investors will pay to insure

against volatility, with the CBOE Vix index down to its lowest since the crisis eve of July 2007, and in sharp reductions in cash cushions held by institutions.

Merrill Lynch's widely followed survey of fund managers . . . finds that more now want companies to pay higher dividends or make more capital expenditures than see them pay down debts. . . .

Such equanimity is not totally irrational. Macroeconomic data in the past month have run ahead of expectations. When the herd trampling forward is this bullish, it is not a good idea to stand in its way. But it would be easier to feel comfortable with current share price levels if investors showed a little more unease. **Complacency on this scale suggests risk of a correction.** (*"Investor sentiment,"* Financial Times, April 14)

Just as one returning swallow doesn't make a summer, anecdotal evidence of rising risk tolerance does not mean entire markets have returned to dangerous levels. But it's a fact that issuers and investment bankers can do things today that they couldn't do a year or two ago. **The door is open to transactions that wouldn't be possible if risk aversion were running high. The clear inference is that fear of loss has declined and fear of missed opportunity has come back to life. That's an important observation.**

Where Did the Unease Go?

Just a short while ago, I believed investors had been sufficiently traumatized that the willingness to bear risk would be absent for years. But it came back in just a matter of months. What explains that?

For one thing, the crisis – as painful as it was – was surprisingly brief. The worst of it began in the third quarter of 2008 with the disclosure of weakness at financial institutions. The onset of the most intense part of the crisis can be dated to Lehman Brothers' September 15 bankruptcy filing. Remarkably, high yield bonds began to recover just three months later, with most of the indices showing gains of roughly 5% for the month of December. So in the credit markets, the worst pain lasted only about three months and quickly gave way to recovery.

© And what kicked off the recovery? Fear of missing opportunity was resurrected by the Fed and other central banks which forced interest rates on short-term government debt to near zero. It might have been the banks' intent, or it might have been an unintended consequence, **but those low rates pushed investors to engage in riskier behavior.** The returns on T-bills and money market funds went to a fraction of a percent, meaning investors had to crawl out on the limb in pursuit of returns they could live with.

Further, governments flooded the system with liquidity and produced the opposite of crowding out. When governments are big issuers of debt, it can be hard for non-

government issuers to raise money. But when governments are big buyers of securities instead, the capital they inject into the markets can make it easy for others to issue securities.

Investors flooded risky companies with money in March even as the government prepares to shut down a key engine driving one of the greatest corporate-bond rallies in history.

A total \$31.5 billion in new high-yield debt, otherwise known as junk bonds, hit the market through Tuesday, exceeding the previous monthly record in November 2006. Partly propelling the activity: The Federal Reserve's massive mortgage-buying program, [which recently came to an end].

By buying \$1.25 trillion of mortgage securities, the Fed absorbed a flood of assets that otherwise would have needed buyers. That kept money in the hands of investors, who went searching for something else to buy. The Fed's underpinning encouraged investors to seek riskier, higher-yielding securities. A natural choice: corporate bonds. ("Bonds Cap Epic Comeback," *The Wall Street Journal*, March 31)

One of the prime tasks investors must perform is to stay alert to extreme behavior and take hints as to what we should do from what we see taking place around us. This is best expressed in Warren Buffett's helpful reminder: "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."

Investor behavior between 2003 and mid-2007 was sending some very worrisome signals. It's obvious in retrospect that all one had to do was take heed and lean in the opposite direction. But observations regarding the past are no help for purposes other than education. For observations to be profitable, they must relate to the present and the future.

Investors have made a substantial move back in the direction of pre-crisis behavior. That behavior has to be recognized and monitored. The pendulum has moved away from the depression, panic, skepticism and excessive risk aversion we saw in the fourth quarter of 2008, and with the disappearance of those characteristics have gone the great bargain opportunities.

Uncertainty and fundamental weakness at the depth of the crisis were offset by irrationally low prices and the potential for a rebound in risk tolerance, making most assets a screaming buy. With most of the great bargains gone – along with excess risk aversion – macro uncertainties should no longer be overlooked. **Thus the caution, discipline, patience, selectivity and discernment that were so unnecessary in 2009 are absolutely essential today.**

* * *

I started this memo in late April, but I didn't get it out before Greece's financial crisis burst into full bloom last week. This gives me an opportunity to discuss the significance of the recent developments (not the substance, however; that'll have to await another memo).

Investing defensively requires that when everything seems to be going well and investors are feeling positive, we must sense the implicit danger and prepare for negative developments.

In the mid-2000s, I began to warn that with asset prices full, investors optimistic and their behavior aggressive, it was important to worry about things that could come along to derail the markets. When asked what they might be, my list of possibilities would go like this:

- recession,
- credit crunch,
- \$100 oil,
- collapse of the dollar,
- exogenous events such as terrorist attacks, or
- something else.

The most dangerous possibility, I pointed out, was the last one. Markets and market participants can adjust to things they see coming. What usually knocks them for a loop are things they don't anticipate. "We're not expecting any surprises" is one of my favorite oxymorons. By definition, surprises are things that aren't anticipated, and thus their arrival can be traumatizing.

Just a few months ago, I published a memo called "Tell Me I'm Wrong" (January 22), in which I listed a number of things that worried me. These included our reliance on government stimulus and artificially low interest rates; the uncertain outlook for consumer spending, jobs and state and municipal finances; and the risks pertaining to inflation, exchange rates and interest rates. Here's how I concluded:

My goal in this memo isn't to express a forecast. I know no forecast – and certainly not mine – is likely to be correct. What I do want to do is caution that the considerable risks I see may be less than fully appreciated by those setting asset prices today. The greatest market risks lie in failure of the macro economy to live up to the expectations embodied in today's prices. . . .

Most people view the future as likely to repeat past patterns, which it may or may not do. They tend to think of the future in terms of a single

scenario, whereas it really consists of a wide range of possibilities. (Remember Elroy Dimson's trenchant observation that "risk means more things can happen than will happen.") And to the extent they do consider a variety of possibilities, few people include ones that haven't been part of recent experience.

The uncertainties discussed above tell me today's distribution of possibilities has a substantial left-hand (i.e., negative) tail, probably greater than at most times in the past. The proper response should be to discount asset prices, allowing a substantial margin for error. Forecasts should be conservative, yield spreads should incorporate ample risk premiums, valuation parameters should be below the long-term norms, and investor behavior should be prudent.

Conspicuously missing from my list of worries was Greece (and all it entails); thus it falls firmly in the category of "something else." Last week it dominated the headlines and depressed markets worldwide. Thus in this short time I have proved two things: first, I know little more than others about what the future will bring and, second, when most investors turn optimistic, it becomes important to worry.

The issue of Greece and its debt has been on investors' radar screens for months, but few people seem to have understood its ramifications and the risks it presented to the markets. Then, in recent weeks, things began to be discussed daily in the media – such as Greece's profligacy and the risks involved in admitting it to the European Union; Europe's lack of an established mechanism for dealing with a problem of this nature; and its reliance on Germany to contribute voluntarily to a solution – that in hindsight it seems should have been obvious. This tells us a few important things about investing:

- Investors generally overestimate their ability to see the future, and the worst of them act as if they know exactly what lies ahead.
- It's important to worry about what's coming next. The fact that we don't know what it is shouldn't permit us to think there's nothing to worry about.
- Low asset prices allow us to invest aggressively, without much consideration given to worrisome fundamentals and the possibility of negative surprises. But as prices rise, so should our degree of concern over these things.

The bottom line is this: the fact that we don't know where trouble will come from shouldn't allow us to feel comfortable in times when prices are full. The higher prices are relative to intrinsic value, the more we should allow for the unknown.

The recovery of 2009 in the face of significant fundamental uncertainty meant that the markets were reincorporating optimism and thus vulnerable to surprise and disappointment. This in itself should be sufficient to induce caution.

May 12, 2010

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Memo to: Oaktree Clients
From: Howard Marks
Re: It's Greek to Me

In the early part of this decade, I reviewed a few books for the *Sunday Los Angeles Times*. Here's how I began my assessment of Pete Peterson's *Running on Empty* in 2004:

Consider Sam. He's always been regarded as the brightest guy in town, and maybe the handsomest. He has the best job and lives in the best house. He spends aggressively – detractors would say hedonistically – to support a lifestyle that many others envy, but he shows good character by providing generously for his sick and elderly relatives.

There are, however, a few problems. In recent years, he's been spending more than he makes, and his expenditures appear likely to grow faster than his income. He covers each year's shortfall by borrowing from other members of the community. (They've always been glad to lend him money because of his good standing in town.) But this adds increasingly to his debt, and thus to the next year's interest (and shortfall). In other words, he seems to follow Winston Churchill's dictum: "It saves a lot of trouble if, instead of having to earn money and save it, you can just go and borrow it."

Finally, with the number of family members Sam cares for increasing, with him promising each of them an increasing stipend, and with his relatives – even the sick ones – living longer, it seems clear that in the future, the cost of supporting them will grow considerably faster than his income.

An annual deficit. Attachment to a lavish lifestyle. Growing indebtedness and related increases in interest costs. Dependence on others to finance the shortfall and the risk that those lenders will withdraw their loans or charge higher interest rates. A commitment to pay for the welfare of others that threatens to grow out of control.

Pete's book focused on the tendency of the United States to ignore the cost of its social programs, run deficits and expand debt, and the "Sam" in my analogy was, of course, Uncle Sam. But now other nations have jumped the line and usurped the above description. Like most of Western civilization, it started with Greece.

Because I was in London much of the time since Greece burst into prominence, I may be able to add some insight from a European vantage point. This period in London was unusual for me, in that with this topic in the headlines I was far more a student than a teacher. Most Americans don't start off sensitized to international economics and, especially, currency matters. It's been challenging to organize all I've learned and boil it down for a memo, but here it is.

Strange Bedfellows

“Shared values” is one of the things I credit for Oaktree’s success over the years. All of Oaktree’s senior managers are conservative, cautious people; we all agree that risk control and consistency hold the keys to long-term investment success; and we all put clients’ account performance ahead of our company’s profit. Shared values make it easy to run an organization and particularly easy to reach agreement on policies and tactics.

Now imagine what it would be like to run an enterprise where (a) some of the constituents believed much more in thrift, discipline and transparency than others and (b) there was no mechanism for making sure everyone played according to the agreed-upon rules. Welcome to Europe.

In the 1950s Belgium, France, Italy, Luxembourg, the Netherlands and West Germany came together to form the European Coal and Steel Community, European Atomic Energy Community and European Economic Community, which in 1967 combined as the European Community. Denmark, Ireland and the U.K. joined in 1973, and Greece, Spain and Portugal joined in the 1980s. Membership has since expanded to 27 nations, and the name “European Union” (E.U.) was adopted in 1993. In 1999, eleven nations (since expanded to 16) agreed to form the euro zone and replace their individual currencies with the euro. Europe seemed to have accomplished the daunting task of pulling together its nations and adopting a single currency. This was a delicate balancing act, but for years it seemed to go quite well.

It was a requirement for success that all the nations share fiscal policy. However, as in most economic alliances, there were incentives to nibble at the rules. And, believing more is better, the E.U. admitted nations with less uniform values. The desire to create a common currency and expand the reach of the union – to achieve a scale more comparable to economic powers like the United States – colored decisions regarding expansion and ultimately led to trouble.

To get a feeling for what happened, let’s say you and I are such good friends that we decide to combine our economic strength to apply together for a credit card with better terms and a higher limit. We agree we’ll each (a) refrain from spending more than we earn and (b) receive and pay that part of the bill that relates to our own charges. All goes well, and eventually we agree to admit a third member to our association. But the new member doesn’t share our commitment to thrift and integrity, wants to live a better life than he can afford, and thus charges more on the card than he earns. Our strong combined credit rating enables him to do so, and his balance on the credit card starts to swell. When it comes out that our association is heavily indebted, we chip in to pay off the unpaid balance, even though only one of us ran it up. In fact, since the prodigal third member spent more than he made, he has nothing to contribute to paying off the debt; thus you and I – despite having behaved more responsibly – are stuck with the burden.

Greece is that new member of the arrangement, and it (like a number of other countries) wanted to give its people a better life than they can afford, financed from the public treasury. Without membership in the E.U. – or if the rules on deficits had been enforced – Greece’s economic reality would have limited what it could do for its citizens. But E.U. membership enabled it to borrow and spend to excess. Here’s what the Bank of Spain’s governor said in April 2007: “The single monetary policy has meant that excessively loose conditions for our economy have been almost continuous” (*Telegraph.co.uk*, May 30). The same was true of Greece.

My English friend Rodney Leach is a Member of Parliament and a committed leader of the “Euroscptics” who have campaigned to improve the E.U. and prevent Britain from adopting the euro in place of sterling. His draft of a coming paper influenced my understanding of the situation: “Once inside the Club,” he writes, “. . . the Mediterraneans resumed their old habits. The temptation was irresistible to borrow at the low interest rates bestowed on them by Germany’s participation. Greece in particular indulged itself by completely abandoning financial discipline.”

Greece was able to violate the agreed-upon 3% cap on E.U. members’ deficits, abetted by generous capital markets and the failure to enforce the limit, and it engaged in financial transactions designed to hide its growing debt. It bears noting that much of what’s true today about Greece has been true for years. But people didn’t understand its significance to the extent they do today, or didn’t find it worrisome, and short-term-oriented politicians had every incentive to ignore the problem rather than confront it and admit that their noble experiment was fraying.

Thus it emerged in early April that Greece and Greek companies had run up substantial debts that would be hard to repay. It didn’t take long for people to figure out that the same was true about the rest of the “PIIGS”: Portugal, Italy, Ireland, Greece and Spain. In May, some unfortunate remarks by Hungary’s Finance Minister made it a candidate for similar treatment. Then Estonia came under the spotlight, and the process seemed to cascade non-stop.

A Problem of Substance

The real problem in Greece and the other countries – especially what Rodney calls the “Mediterraneans” – isn’t one of deficits and debt. Those are merely the results and the symptoms. And if the problem were Greece alone, the smallness of its economy and financial system would render it easily fixable. The problems are more substantial, structural and widespread. (I looked at 17 European nations; they all ran deficits in 2009, and only two of those deficits were below the E.U.’s target of 3% of GDP. In ascending order, the deficits in Belgium, Cyprus, Slovakia, France, Portugal, Spain, the United Kingdom, Greece and Ireland were all between 6% and 14%.)

The ingredients that contributed to the European crisis are many:

- Slow-growing, unproductive and uncompetitive economies.
- Low birthrates and aging populations. (“In the 1950s there were seven workers for every retiree in advanced economies. By 2050, the ratio in the European Union will drop to 1.3 to 1.” – *New York Times*, May 23)
- Generous benefits and social services; cradle-to-grave safety nets.
- Extensive vacations and strict limits on the work week.
- Early retirement.
- Artificially high debt ratings and resultant low interest rates.

In “What Worries Me” (August 28, 2008), I expressed concern about the fact that Americans expect the world’s highest standard of living even though the U.S. is no longer a leader in manufacturing output and global competitiveness. Certainly this is the case in spades for Greece, whose economy is largely irrelevant but which wanted to meet its people’s demands.

In April, as the problem began to unfold, I heard a Greek taxi driver express his worry on the radio: “I might not be able to retire at 53,” the average retirement age. How can it be rational for a nation with a limited economy to enable its citizens to retire at age 53? Well, it isn’t. Greece was able to outspend its revenues for years because it benefited from the “reflected halo” of the E.U.’s financial strength and low euro-related interest rates.

On June 4, 2005, the *International Herald Tribune* carried an op-ed piece by Thomas Friedman in which he presciently observed the following:

. . . [the forces of globalization are] eating away at Europe’s welfare states. It is interesting because French voters are trying to preserve a 35-hour work week in a world where Indian engineers are ready to work a 35-hour day. Good luck. . . .

I feel sorry for Western European blue-collar workers. A world of benefits they have known for 50 years is coming apart, and their governments don’t seem to have a strategy for coping.

A few weeks ago, Franz Muentefering, chairman of Germany’s Social Democratic Party, compared private equity firms which buy up failing businesses, downsize them and then sell them to “a swarm of locusts.”

The fact that a top German politician has resorted to attacking capitalism to win votes tells me just how explosive the next decade in Western Europe could be, as some of these aging, inflexible economies which have grown used to six-week vacations and unemployment insurance that is almost as good as having a job become intimately integrated with Eastern Europe, India and China in a flattening world. . . .

Next to India, Western Europe looks like an assisted-living facility with Turkish nurses.

In a nation with closed borders, a government can do almost about anything it wants. It can print money with which to buy things for people who don’t earn those things themselves . . . as long as sellers will accept that newly printed money at face value. **But in a global economy, competitive forces make it hard for people – or countries – to live better than their output justifies.**

Less fundamental but more colorful, I’ve learned about a number of factors which exacerbate the situation in Greece and elsewhere. While just anecdotal, these tales are rampant in Europe:

- As may be typical of Mediterranean nations, compliance with Greek tax laws is, shall we say, “spotty.” In this country of 11 million people, just a few thousand report incomes above €100,000.
- There’s a box to check on the tax form if you have a swimming pool, and 324 residents of Athens said “yes.” However, when tax investigators checked satellite photos, they got a slightly different figure: 16,974. That’s 2% compliance. (*The New York Times*, May 10)
- As part of the unorthodox arrangement, these countries have significant “black” or “shadow” economies. In Greece, 20-30% of transactions are said to take place in cash and/or through overseas bank accounts, unreported in both cases.
- The prevailing rule in Greece seems to be “4-2-4.” If you have a pending tax obligation of €10, you meet with the tax collector. You hand him four for himself, you pay the authorities two, and you keep four. It’s not a fluke that the typical Athens tax collector, with a salary of €50,000, is said to own real estate worth €2 million.
- Going the proverbial baker’s dozen one better, workers in Greece’s public sector had quite a deal: they were paid two “bonus months” per year.
- In Spain, half of all employees are unionized and protected by very strict work rules that limit efficiency and essentially preclude layoffs. This means any steps to cut costs fall on the rest of the work force, which is hit disproportionately.
- It seems that Italy (an E.U. founder but also a “Mediterranean”) maintains “a fleet of more than 626,000 official cars, more than 10 times the number in France, Germany or the UK.” (*Financial Times*, May 12)

Together these things – low output, high government spending, under-the-table business dealings, tax evasion, and financial profligacy – represent a recipe for trouble. **Today’s developments merely prove that things that don’t make sense can’t go on forever:**

- Perpetually spending more than you bring in.
- Enjoying a standard of living you can’t afford.
- Running an annual deficit that increases constantly as a percentage of GDP.
- Owing amounts that increase constantly as a percentage of GDP.
- Doing all the above while having a currency as strong – and an interest rate as low – as in nations where these things are not the case.

Things can go on longer than they should, and these probably have, but eventually there’s a price to be paid. The world is up in arms today over everything that’s wrong with the European financial picture, even though these conditions probably aren’t much changed from a few years ago. It’s just that now people have decided to focus on them.

The Role of Debt

As I mentioned above, debt isn’t the problem, or the cause of the problem. But it has been the facilitator.

In “The Long View” (January 9, 2009), I wrote (albeit without reference to Greece) about a strong uptrend over the last few decades in what I called “expansiveness”:

Every business, government, non-profit organization or individual has a certain amount of equity capital, net worth or surplus. That capital, in turn, will support a certain level of activity: production and sales, lending, government action, charitable grants or consumption. **But over the last several decades, if you wanted to do more of these things than your capital permitted, you could borrow capital from someone else.**

Without credit – I think back to my pre-credit card college days of 45 years ago, for example – you couldn't spend money you didn't have. Thus you couldn't buy things you couldn't afford. Then the miracle of credit came along and it became easy to get in over your head.

What would have happened if governments couldn't finance deficits by issuing debt? Greece would only have been able to pay the benefits it could afford. Less pleasant, but perhaps healthier.

And what would have happened if builders weren't able to borrow, and thus had to sell each newly built home before they could erect the next? Spain wouldn't have been the site of a boom in which 2.8 million homes were built (with only 1.5 million sold), and with as many building permits issued as in France, Germany, Italy and the Netherlands put together.

The Wall Street Journal of November 24, 2008 carried the following quotation from Irving Fisher, writing 76 years ago (“The Debt-Deflation Theory of Great Depressions,” *Econometrica*, March 1933):

When it comes to booms gone bust, “over-investment and over-speculation are often important; but they would have far less serious results were they not conducted with borrowed money.”

While this statement wasn't made with regard to Greece or even to government activities in general, it is clearly relevant to the current situation.

In recent years, most of the nations of the world spent more than they took in to give their citizens more of what they wanted. As long as the capital markets were open, few could think of a reason why this policy wouldn't work forever. Economic units all over the globe were able to borrow to cover deficits. All that mattered was the ability to service the debt, even if that required borrowing money to pay interest. No one seemed to demand the ability to repay.

When I was younger – in what seems like a distant past – national debt began to expand, and I remember heated debate regarding the significance, wisdom and likely consequences of that trend. The subject receded in recent years, since every nation now does it to some extent and people became inured to the controversy, as they tend to do.

Two sentences stand out on this subject, from Bill Julian of Bill Julian Research on April 11. He quotes John Maynard Keynes as having said, “Government debt is really debt we owe to ourselves. So it doesn't matter.” But today, most nations' debt is no longer all “to ourselves,” as nations with surpluses are largely financing the ones with deficits. Thus it's hard to conclude national debt doesn't matter. Welcome to 2010.

In the “old days,” government deficits were often part of counter-cyclical stimulus, a concept with which Lord Keynes is identified. It seems logical that when its economy is depressed, a nation will spend more than it receives in taxes in order to stimulate. Then, in times of prosperity, it will cut expenditures, run a surplus and pay down debt. But permanent deficits appeared in the late twentieth century, and thereafter national debt has grown in good times and bad. The idea of national debt being repaid has evaporated. Today, public and private institutions in Greece, Spain and Portugal owe €2 trillion to foreigners, with no possibility of repayment in sight.

Solutions and Stumbling Blocks

Thus far, most of the actions being taken to address the crisis are of two types: financial maneuvers to calm the financial markets in the short term, and austerity measures designed to reduce deficits in the long term.

The United States’ credit crisis of late 2008 serves as a model for what must be done. The elements that arise in a credit crisis are consistent: uncertainty regarding the future, fear of credit losses, and refusal to make loans. **Financial systems run on confidence, and, when confidence dries up, things can grind to a halt.** Clearly, then, the most immediate efforts must be to restore confidence and keep credit flowing.

This problem is particularly severe at financial institutions (and what is a national economy today other than a financial system, hopefully with a manufacturing sector tacked on?). Financial institutions are, by definition, marked by high leverage, and if confidence declines, the providers of credit tend to ask for their money back. Since these institutions never have enough cash on hand to satisfy the demands of the would-be withdrawers, they can fall prey to a run on the bank. The first task, then, is to restore confidence and keep capital available.

Thus, at the beginning of May, the E.U. put together a rescue package for Greece worth €10 billion. And then, when the possibility of contagion to Spain, Italy and Portugal began to be recognized, that was increased on May 10 to €750 billion (or \$900 billion, a figure remarkably similar to the U.S.’s program). In addition, the European Central Bank established a program to buy government bonds of the affected nations, along the lines of our “quantitative easing.”

Many European governments have announced plans to reduce deficits. Their tactics include reduced spending, freezes or cuts in public sector employment and wages, and higher retirement ages. Some have enacted tax increases to augment revenues. Greece even says it’s going to start collecting more of the taxes that are owed. Austerity is all the talk in Europe, and some leaders are predicting periods of substantial suffering. That’s what happens when a borrow-and-spend cycle that has advanced beyond prudence is brought to a halt.

It’s important to recognize, however, that one potential solution – traditionally perhaps the easiest – isn’t available to the members of the European Union: currency devaluation.

A key element in the situation is the absence of independently floating exchange rates. Think for a moment about international finance. Countries differ in terms of growth rates, productivity and inflation rates. In recognition of the differences, interest rates and exchange

rates change relative to those of other countries. In general, countries that are better off in terms of growth, productivity and inflation will have stronger currencies and pay lower interest rates.

The easiest way for a nation with excessive foreign debt to solve its problem is through devaluation. If the drachma weakens relative to the deutschemark, a Greek who owes a German a certain number of drachmas now owes him fewer deutschemarks (of course, if the debt is denominated in deutschemarks, he now owes him more drachmas). This process can occur through an explicit devaluation or through hyperinflation, and we'd be overwhelmingly likely to see it in action from a standalone Greece.

Between 1980 and 2000, the drachma depreciated by roughly 85% relative to the deutschemark, a reflection of economic reality. But with the countries of Europe tied together with a single currency, this can't happen.

Nations throughout Europe are doing what they can. That means reassuring financial markets and implementing austerity measures, but not devaluing (as long as the debtor nations in question remain part of the E.U.).

So, Will It Work?

"Will It Work?" was the title of a memo I wrote on March 5, 2009, discussing whether the Obama administration's rescue plan would be successful. The problems were new and huge, like today's in Europe, and the solutions being attempted were untested, also like today's.

The last section of "Will It Work?" was devoted to the three things I said had to be accomplished in order for the rescue to be effective: delever the economy, replace the capital that has been destroyed, and restore confidence. The recipe in Europe is no different, although the U.S. government had to shore up the financial institutions, whereas in Europe governments first have to support other governments.

In addition, there are wrinkles in Europe that the U.S. didn't face to the same degree. They can make it challenging to solve problems and especially to reach agreement quickly:

- The European Union consists of 27 sovereign nations, each with its own central bank and finance ministers. In addition there are the European Central Bank ("ECB"), the European parliament and the E.U. ministers.
- The countries have very different political views and are led by people from all over the political spectrum.
- The approach of nations to the problem will be colored by history that in some cases includes war and occupation. Countries will be asked to bail out others they fought against in the past.
- Finally, the countries' financial status varies widely. Only a few – primarily Germany – can contribute meaningfully to a bailout, and they will be asked to carry the vast majority of the burden. Will they be willing to do so?

As an indication of the intra-European differences, *The Wall Street Journal* said the following on June 15:

Germany views the crisis on the euro zone's Southern fringe as a symptom of other countries' failure to copy Germany's fiscal discipline and structural overhauls to its economy. Its proposed remedies focus mainly on pushing other countries to cut budget deficits.

France, however, believes Germany's large trade surplus and weak domestic demand are part of the euro zone's problem, since they force weaker economies to pay for their imports with debt, rather than through exports to the German market, Europe's biggest.

In addition to political complexity, efforts to solve the problem will run into two important issues:

- **Austerity measures and tax increases are anti-stimulative, and they are being applied at a time when the economies in question are weak and need stimulus. Economic historians such as Ben Bernanke recognize that adding liquidity is the best way to deal with a slowdown, and that the withdrawal of liquidity exacerbated the Great Depression.**
- **In the long run, reducing deficits and debt will not be enough. The countries in question have to increase their productivity and competitiveness.**

In "Will It Work?" I quoted from Paul Krugman (*The New York Times* of February 16, 2009):

As the great American economist Irving Fisher pointed out in the 1930s, **the things people and companies do when they realize they have too much debt tend to be self-defeating when everyone tries to do them at the same time.** Attempts to sell assets and pay off debt deepen the plunge in asset prices, further reducing net worth. Attempts to save more translate into a collapse of consumer demand, deepening the economic slump. (Emphasis added)

The yoking together of the European nations introduces some interesting ramifications. Some Northern European export economies – Germany in particular – are doing quite well. At this stage of the cycle, they might be considering rate increases and their currencies might be strengthening. But it's doubtful the ECB will raise rates anytime soon, and the euro has weakened versus other currencies. Thus, for example, the German economy and German exports will be stimulated when they arguably don't need it. Germany will export more than it otherwise might have, with some of its gains recirculated in the form of aid to other countries. Good so far, but possibly inflationary. Complicated and not easy.

The analysis of sovereign debt is in large part political, not economic. Thus the open questions are political, as described above, complicated by the multi-national aspect of the E.U. and the absence of provisions for disciplining financial non-compliers, ejecting members or winding down the Union.

But as we saw in the U.S. in 2008 and 2009, there should be little doubt that everything possible will be done to save the euro and the E.U. (albeit perhaps with one or two fewer members and/or a touch of “debt rescheduling”). They’re likely to continue to exist, but many of the key questions in Europe surround the level of economic vibrancy we’ll see.

My purpose in writing this memo was to summarize and explain the developments in Europe, and that’s the vein in which I started. But then I started to think more broadly.

We Have Met the Enemy and He Is Us

According to *The New York Times*, a leading central banker addressed his legislature on June 9 regarding his country’s fiscal operation, which he said “appears to be on an unsustainable path.”

“**A variety of projections** that extrapolate current policies and make plausible assumptions about the future evolution of the economy,” he said “**show a structural budget gap that is both large relative to the size of the economy and increasing over time. . . .**”

“In addition, government expenditures on health care for both retirees and non-retirees have continued to rise rapidly as increases in the costs of care have exceeded increases in incomes. **To avoid sharp, disruptive shifts in spending programs and tax policies in the future, and to retain the confidence of the public and the markets, we should be planning now how we will meet these looming budgetary challenges.**” (Emphasis added)

Greece? No. Spain? No. Portugal, Italy or Great Britain? None of the above. **That was Ben Bernanke speaking before the Budget Committee of the House of Representatives.** Thus my use above of the most famous line from Walt Kelly’s comic strip “Pogo.” Greece and the other members of “Club Med” may be on the hot seat today, but few developed nations are exempt, and certainly not the U.S. The differences between the countries in the headlines and many others are matters of degree, not kind.

David Leonhardt’s column in *The New York Times* of May 12 provides a good way to start in on this subject:

It’s easy to look at the protesters and the politicians in Greece – and at the other European countries with huge debts – and wonder why they don’t get it. They have been enjoying more generous government benefits than they can afford. No mass rally and no bailout fund will change that. Only benefit cuts or tax increases can.

Yet in the back of your mind comes a nagging question: how different, really, is the United States?

The numbers on our federal debt are becoming frighteningly familiar. The debt is projected to equal 140 percent of gross domestic product within two decades. Add in the budget troubles of state governments, and the true shortfall grows

even larger. Greece's debt, by comparison, equals about 115 percent of its G.D.P. today.

The United States will probably not face the same kind of crisis as Greece, for all sorts of reasons. But the basic problem is the same. Both countries have a bigger government than they're paying for. And politicians, spendthrift as some may be, are not the main source of the problem.

We, the people, are.

We have not figured out the kind of government we want. **We're in favor of Medicare, Social Security, good schools, wide highways, a strong military – and low taxes. Dealing with this disconnect will be the central economic issue of the next decade, in Europe, Japan and [the U.S.]. . . .**

As societies become richer, citizens tend to want better schools, better medical care and other government services. [The U.S.] is following that pattern, but without paying the necessary taxes. That combination has us on a course to Greece-like debt.

As a rough estimate, the government will have to find spending cuts and tax increases equal to 7 to 10 percent of GDP. The longer we wait, the bigger the cuts will need to be (because of the accumulating interest costs).

Seven percent of GDP is about \$1 trillion today. In concrete terms . . . the combined budgets of the Education, Energy, Homeland Security, Justice, Labor, State, Transportation and Veterans Affairs Departments are less than \$600 billion. (Emphasis added)

Leonhardt provides some data for “cyclically adjusted primary balance as a percentage of GDP” that make for frightening comparisons:

Portugal	- 2.8%
France	- 3.7
Spain	- 5.6
Greece	- 6.0
Iceland	- 6.5
Britain	- 6.8
United States	- 7.3
Ireland	- 8.2

The Times defines “primary balance” as “. . . a measure of each country's medium-term deficit as a percentage of GDP excluding interest payments and assuming that unemployment in all countries drops significantly (to what economists consider ‘full employment’).” In other words, these projections incorporate a good bit of optimism. The U.S. deficit is swollen by stimulus measures that should shrink, but the data still make us look bad in some pretty bad company.

The U.S. is better off than Europe in a number of ways:

- Its national debt isn't high as a percentage of GDP (according to CIA data, our ratio in 2009 was only 53%, versus 113-115% for Greece and Italy, and 62-77% for the Netherlands, the United Kingdom, Germany, Portugal and France).
- It benefits from having the world's primary reserve currency.
- Its Treasury securities are still a primary destination during any flight to quality (thereby reducing its interest costs).
- It possesses advantages in terms of top educational institutions, natural resources, creativity and intellectual progress.

On the other hand, its drawbacks include a tradition of deficit spending; heavy total indebtedness (especially at the household level); many of the demographic issues that I described as affecting Europe (e.g., aging population, potential for structurally high unemployment); costly entitlement programs; declining competitiveness and a shrinking manufacturing base.

Including the private sector, total U.S. debt stood at 358% of GDP in late 2008. That compares to about 200% of GDP prior to the Great Depression and a peak of 300% in 1933 (sources: Bureau of Economic Analysis, Federal Reserve and Census Bureau). **The U.S., too, will have to go through some major belt-tightening . . . painful if it starts soon, but much more so if it is delayed until the future promises are allowed to build up further.**

I think David Brooks put it very well in *The New York Times* on May 13:

If you're elected president or prime minister in pretty much any country in the developed world today, you're faced with the same set of challenges: to reduce national deficits without choking off a fragile recovery; to trim the welfare state and raise taxes while still funding the things that lead to long-term growth; to try to enact brutally painful measures at a time when voters don't trust their leaders; to do it at a time when politics are polarized and a hundred different interest groups have the ability to block change.

The chances that the world's leaders are going to be able to do these things successfully are between slim and none. It's hard enough to figure out the right mix of spending cuts and tax increases. It's nearly impossible to build a political majority willing to enact them. Sometime over the next decade or so, the world will probably suffer from another series of crushing fiscal crises with significant economic pain and maximum political turmoil.

While Brooks led off with the paragraphs reproduced above, he found "Glimmers of Hope" (the title of his column) in the constructive budgetary approach being adopted by the new governing coalition in Great Britain.

This assessment from the Milken Institute should provide some motivation for problem solving:

By 2020, trillion-dollar deficits will become the norm even in years of solid economic growth and low unemployment, rather than an unpleasant aberration linked to a deep recession.

Absent wrenching changes in fiscal policy, things will only get worse after that. The retirement of the baby boom generation and the growth of health costs at a rate far faster than the growth of GDP mean that government spending on Social Security, Medicare and Medicaid (which pays for most nursing-home care for the elderly) is likely to explode. By the nonpartisan Congressional Budget Office's reckoning, spending on those three programs alone is expected to reach 18 percent of GDP in the year 2040. That is the average level of revenues, measured as a portion of GDP, that the federal government has collected over the past 50 years. So, in this scenario, there would be nothing left to pay for everything from defense to interest on the debt. Thus, unless those entitlement programs (and other spending) can be drastically curtailed or taxes raised significantly, large and growing deficits are a certainty.

But the auguries aren't good. Both political parties have become advocates of low taxes. President Obama's State of the Union address was a veritable panegyric to the virtues of tax cuts (although he is willing to raise taxes a bit for the rich in general, and rich bankers in particular). And now that Republicans have become defenders of spending every last dollar that Medicare recipients are currently promised, the prospect of reining in entitlement programs seems more remote than ever.

In a politics-as-usual scenario, with no changes in the current policy of low taxes and unrestrained entitlement growth, the federal debt is projected to reach 100 percent of GDP by 2023. By 2038, it would reach 200 percent of GDP.

I'll close on this subject with some even more pessimistic words from Bill Julian:

Add to the debt woes of European nations and US states the unfunded liabilities of the US government (\$30 to \$50 trillion, depending on who you ask) the bearded nationalization of the largest financial institutions in the world, Fannie and Freddy, and you have to ask, how could it have gotten this bad?

. . . conditions of instability could reappear [quickly]. And this time, the crisis will center on government debt and the bond markets. The collectivist impulse spawned by Keynes as a solution to fiscal problems brought on by the bad behavior of the banks and the governments who cover for them will have gone as far as they can. There will be no one left to bail out "the system." The US government will be left with a nasty choice: austerity and fiscal discipline, or monetizing the debt [through devaluation or hyperinflation] and face a likely collapse of the bond market.

The bottom line appears to be that the U.S. must anticipate austerity, higher taxes, and the sluggish growth that combination is likely to produce. Failing that, we may face devaluation, default and other unthinkable developments. We are not exempt from the problems besetting Greece, or the awakening regarding the notions listed on page 5.

The State of the States

Many professional investors include *What I Learned This Week* from 13D Research among their highest-priority reading. Its discussions are big-picture and almost academic, but Kiril Sokoloff seems more likely than most to cover the big market-movers of tomorrow. He discussed the financial condition of the states in his June 24 issue, and I can't resist quoting extensively (I could give you more, but there has to be a limit):

Across the U.S., state governments are on the edge of fiscal calamity . . . Last month, a report from the U.S. Center on Budget and Policy Priorities issued estimates that in fiscal 2010 the U.S. states collectively posted a near \$200 billion budget shortfall, equivalent to 30% of all state budgets. As *Time's* David von Drehle recently observed: "*Such persistent budget woes are unparalleled in the era of modern American government. You'd have to go back to the 1930s to find a parallel.*"

After plunging in 2009, tax revenues are starting to stabilize in some places, but revenues are still far off pre-recession levels. Collection of sales, personal-income and corporate taxes – which constitute 80% of state revenue – slumped 12% over the past two years. Meanwhile, fixed costs continue to keep states deep in the red.

As would be expected, state and local governments have begun to take some much-needed steps – cutting costs, trimming pension eligibility, and depleting their rainy-day funds. In fiscal 2010, forty-five states reduced services to residents and over 30 states have raised taxes, in some cases significantly, according to the Center on Budget and Policy Priorities. **Fourteen states are expected to have reserves of less than 1% of their annual spending by the end of fiscal 2010 – they are basically living hand-to-mouth. . . .**

But **the states, it must be remembered, have a large number of fixed costs, which continue to expand.** In addition to soaring pension obligations, the federal government has pushed a lot of its burdens onto the states, beginning with the sprawling mess that is Medicaid. Created by Congress, administered by the states, and funded by a mishmash of state, local and federal funds, *the healthcare system for America's poor is a train wreck waiting to happen.*

Medicaid spending, which accounted for 21% of state general fund expenditures in 2009, rose 6.6% that year and is expected to rise 10.5% in fiscal 2010, according to Linda Bilmes, a professor at the Harvard Kennedy School. But while the number of enrollees increases, funding for the system will barely budge. As Arizona's Governor Jan Brewer said in her state-of-the-state

address this year: “Government revenues have sagged to 2004 levels and some people say we should just adopt the 2004 budget” – easier said than done when your state’s Medicaid rolls have grown by nearly half a million since then. . . .

The states, like the federal government, are facing a demographic headwind that will continue to shrink their tax revenues and compound their growing social safety net obligations. As Graham-Fisher’s Josh Rosner reminds us, the baby boomer’s peak earnings potential is behind them:

These boomers are now moving to become the largest tax on the social safety net. The largest generation in U.S. history will retire with less equity in what has historically been the largest retirement and intergenerational wealth transfer asset for most families – their homes. In many cases, these people will have no new [sic] personal savings when they reach the end of their working lives and will essentially become wards of the state. This increased burden on the U.S. Treasury, in a decade, is the largest unconsidered impact of the current crisis.

Last year, the states’ fiscal woes were partly assuaged by the federal stimulus package. But nearly 70% of the \$787 billion of stimulus funds approved early last year will have been spent by September, according to the CBO. (And while the emergency cash infusion helped the states keep their heads above water, it ultimately compounded their plight, since even though the federal funds are not necessarily recurring, the jobs and obligations they fund are.) This year, however, **the federal stimulus money is going to be thinned dramatically.**

The Obama administration has asked for about \$50 billion for 2011, but *experts believe it would require another \$160 billion in cash just to meet demands for the next two years.* And this assumes there is no increase in unemployment or decrease in tax revenues. Even though there is scant appetite among election-susceptible Democrats in Washington to add more zeroes to the end of the federal deficit, there may be no alternative. If the federal government does not intervene, the entire U.S. economy could be put at risk. **After all, aren’t California and Illinois, like the country’s banks, “too big to fail”?** (Emphasis in the original)

I touched on the subject of the states’ fiscal condition in “Tell Me I’m Wrong” (January 22); that and the passages above from Sokoloff’s piece should suffice for now. However, I do want to go into a bit more detail regarding one of the key contributors to Greece’s troubles: pensions.

Pension promises have long been used in the U.S. as a budgetary quick fix. As in some parts of the private sector (see auto companies and “legacy” airlines), the public sector has a history of substituting sweetened pension benefits (and retiree medical benefits) for higher wages in the here-and-now, a prime example of “kicking the can down the road.” Employees bargained for promises of enhanced retirement payments in exchange for agreeing to limit increases in current compensation, but the cost of keeping those promises will be high and, as of today, is far from fully funded.

The Pew Center on the States estimates that as of June 30, 2008, the states had set aside \$1 trillion less than would be needed to pay future pensions and medical benefits. On July 6, *The New York Times* reported on a study by Joshua Rauh of the Kellogg School of Management: “. . . assuming states make contributions at recent rates and . . . earn 8 percent, 20 states will run out of cash by 2025; Illinois, the first, will run dry in 2018. . . . Illinois, once its funds were depleted, would be forced to devote a third of its budget to retirees; Ohio fully half.”

States such as California and Illinois clearly have debts that will be hard to pay and budgets that will be hard to balance. Fractious politics, the requirement for super-majorities on tax and budget matters, and the role (in my state) of referenda all render solutions elusive. **Will there be a bailout?** This is a great question to start thinking about today (although the prevailing ethic is to not worry about anything until doing so is absolutely unavoidable).

I have no doubt that the federal government wants to avoid a bailout at all costs, and that the rhetoric will remain staunchly anti-rescue. But when push comes to shove, I sincerely doubt a state will be permitted to go bankrupt. As Warren Buffett said at this year’s Berkshire Hathaway annual meeting, “I personally think it would be very hard, in the end, for the federal government to turn away a state that is having extreme financial difficulties.” (*Financial Times*, May 4)

Just as the E.U. doesn’t want to give deficit spending a green light, fiscally responsible states don’t want to pay debts that others created through overspending. **If the federal government were to bail out a defaulting state, what would keep any state from running deficits, knowing they could count on others to pay off their debts? When overspending isn’t punished, what is there to discourage it? What better example is there of moral hazard?** Wouldn’t it actually be irrational for a state politician to vote to deny his constituents a benefit if he knew the tab eventually would be picked up by others?

And by the way, like Europe, the U.S. has its own differences. Certain regions will be asked to foot the bill for others in a federal bailout. And certainly some states have been more “expansive” than others and have run up bigger debts. All just like in Europe. In the same way that Germans may be hesitant to bail out free-spending Greece, Texans may think twice about bailing out California, and North Dakotans may have doubts about New York. “Red” states are unlikely to leap to help struggling “blue” states given the Republican view that Democrats over-expand the role of government.

* * *

Experience shows how radically markets fluctuate between seeing the proverbial glass half full and seeing it half empty. Rather than achieve a happy medium, sometimes the markets focus exclusively on good news (as during the twelve months through April) and sometimes exclusively on bad. Greece kicked off a turn to the negative in late April, which was exacerbated by the Gulf oil spill and rising concern over the possibility of an economic double dip. On May 8, after Greece’s troubles blossomed, *The New York Times* quoted Bill Gross as saying, “Up until last week there was this confidence that nothing could upset the apple cart as long as the economy and jobs growth was positive. Now, fear is back in play.”

Just a few months ago, no one seemed to have a problem with nations that ran chronic deficits and continuously increased their debt. Then investors changed their mind – as they tend to do – and today they take a dim view of these practices. Government solvency is considered a critical issue. Here's how guest contributor and hedge fund analyst Andrew Marks (also my son) sums up current sentiment:

Sovereign debt has become like fiat currency, as it is supported only by people's willingness to believe in other people's willingness to refinance it. The debt of an issuer with no plan to repay and no underlying way to meet maturities other than through refinancing sounds eerily like a subprime mortgage.

Markets are safer when fear balances greed, and when worry about losing money balances worry about missing opportunity. We don't like it when fear rears its head and stocks drop, but certainly that creates a healthier environment in which to be a holder, and one which should offer better buying opportunities. **Over the first part of this year it was easy to say prices had gotten ahead of fundamentals; all things being equal, that now seems less true.**

The current positives for investors include moderate valuations, rising corporate earnings and the likelihood we're already in a recovery. On the other hand, I continue to feel consumers are too traumatized to resume spending strongly, and I see unpleasant and rarely contemplated long-term possibilities including those discussed above. In particular, conservatism, austerity and increased savings are good for economic units individually but bad for a stagnant overall economy. **Bottom line: anyone who invests today in a pro-risk fashion out of belief in the recovery must be confident he'll be agile enough to take profits before the long-term realities set in.**

I've had a heck of a time pulling together all of these ideas, and I've found it even harder to come up with anything like answers. But I hope the discussion has been helpful, and that you'll think about the questions I've raised and encourage others to do so as well. **I don't enjoy feeling like a worrywart, but I doubt my concerns are unfounded, and I can't imagine silence would be preferable.**

July 19, 2010

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Memo to: Oaktree Clients

From: Howard Marks

Re: Hemlines

While the details change, the pendulum-like fluctuation of investment styles is a constant. Fear versus greed, pursuit of safety versus aggressiveness, stocks versus bonds, and growth versus value are just a few examples of the areas in which we see this take place. In this way, the investment world proves the wisdom of Mark Twain's observation that, "History doesn't repeat itself, but it does rhyme."

The limits of the pendulum's swing are fixed, and it tends to move back and forth over the territory between them. This occurs because (a) people tend to take trends to extremes, (b) neither extreme of the pendulum's arc represents a perfect or permanent solution, and (c) there's no place else to go in these regards. **Thus the best way to view investment trends may be through an analogy to hemlines: all they can do is go up and down, and so they do.** The style mavens call for short skirts, and people fall into line, raising hemlines until they're as high as they can go. And then they drop (and so forth).

The reasons behind the rise and fall of investment fashions rarely repeat exactly, in that the details, timing and effects vary from instance to instance. But the underlying process is a recurring one. For example:

- An idea is born when an undervalued asset is discovered.
- Its undervaluation attracts attention, as do pioneering investors' early gains.
- Its popularity rises, attracting more and more adherents, even as undervaluation moves to fully valued.
- It turns into a mania or "bubble," and price becomes immaterial.
- Eventually, the last potential buyer becomes convinced and comes on board.
- With no one else left to convert to the trend, the bubble of overvaluation is ripe for bursting.
- When followers experience the first price declines, disillusionment sets in.
- One-time devotees flee en masse, and the bubble turns into a crash.

This cycle of discovery, mania and crash is best summed up by the most useful of all investment adages: **"What the wise man does in the beginning, the fool does in the end."** This memo will be about recurring patterns, the history of stocks and bonds as I know it, and the adage's applicability to that history.

A Brief History of Stocks

A significant milestone occurred in October 2008, attracting a lot of attention. For the first time in almost fifty years, it was reported, the dividend yield on the Standard and Poor's 500 stock index was equal to the yield to maturity on the U.S. 10-year Treasury Note. People knew this meant stocks had cheapened, but it took an understanding of history to grasp the real significance. **The truth is that stocks, like other investment media, tend to go in and out of style, and this was just one more example of the latter.**

Prior to the 1950s, common stocks were viewed as a speculative, inferior (i.e., junior) asset class. For that reason, stocks had to pay higher yields than bonds in order to attract buyers; of course a riskier asset should yield more. In fact, most states had laws restricting holdings of stocks in fiduciary portfolios. This attitude toward stocks largely traced from the speculative stock bubble in the 1920s – featuring high-margin buying, bucket shops and shoe shine boys sharing stock tips – which collapsed in the Crash of '29. Poor economic and market performance stretching from 1929 to the end of World War II further contributed to the skepticism toward stocks.

It was only after WW II that economic performance began to support optimism. Brokerage firms led by Merrill, Lynch, Pierce, Fenner and Smith trumpeted the merits of stocks. Equity investing became widespread, and “customers’ men” in local brokerage offices delivered stock investing to a great many households: I remember my mother buying 10 shares of Columbia Gas and 15 shares of Chock Full of Nuts around 1959.

I also remember a brochure on “growth stock investing” that Merrill put out in the mid-1960s, touting the desirability of rapid earnings growth and the strength of companies like IBM, Xerox, Avon, Coke, Texas Instruments and Johnson & Johnson. This idea grew into “nifty-fifty” investing, a true mania adopted by many of the large banks, among others. Ballyhoo took over from logic – excitement from value-consciousness – and these growth stocks’ prices reached 80 and 90 times earnings.

The nifty-fifty stocks were tested – and found wanting – when the tide went out in the 1970s. Prosperity shifted to recession. The Arab oil embargo, a period of strong cost-push, and self-reinforcing cost-of-living adjustments created hyperinflation to which few people saw a chance for an end. Those growth stock p/e ratios went from 80 or 90 to 8 or 9. And stocks, Wall Street and the general economy went through a truly dreary decade, culminating in a *BusinessWeek* cover story entitled “The Death of Equities,” in August 1979. For evidence of the cyclicity of attitudes toward stocks, consider its final paragraph:

Today, the old attitude of buying 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 fogies. The stock market is just not where the action is.”

In the investment world, lows in sentiment usually coincide with lows in price, and the late Seventies were no exception. Because of the dreadful environment, you could buy an existing company in the stock market for less than it would cost to start one. I was fortunate to become a portfolio manager in mid-1978, and thus to benefit from the subsequent recovery of investor psychology from its nadir.

In general (albeit with some prominent exceptions), the last half of the twentieth century was marked by the rise of a cult of equities, and the last quarter century was probably the best ever. From 1979 through 1990, the S&P 500 averaged an annual return of 15.4% and showed losses in only two years (4.8% in 1981 and 3.1% in 1990). Economic prosperity, rising corporate profits, a trend among consumers toward borrowing to spend, and the subsidence of inflation and interest rates all made for a most hospitable environment.

When the stock market’s performance improved even further in 1991-99, with an average return of 20.6% and no down years, the fawning kicked up a notch. From the low of 7 reached in 1980, the p/e ratio on the S&P 500 eventually exceeded 33 in 1999. The market’s dramatic

performance led to steady increases in the capital allocated to equities, and eventually to the tech stock bubble. It culminated in books such as the fact-based *Stocks for the Long Run* and the more fanciful *Dow 36,000*. If you asked institutional investors what return they expected from stocks going forward, I think just about all would have said 11%.

An aside: investors consistently seize upon above average returns as an encouraging sign and extrapolate them, and the 17.6% compound return on the S&P 500 from 1979 through 1999 was certainly a case in point. But rarely do they ask what gave rise to those good returns, or what it implies for the future. In essence, stock ownership conveys the benefits of owning a corporation, and stock appreciation should be powered by increases in profits. Thus long-run returns should reflect corporate growth. But as Warren Buffett has pointed out, “. . . people get into trouble when they forget that in the long run, stocks won't appreciate faster than the growth in corporate profits.” Although that growth is the underlying source of equity profits, it is often overshadowed and obscured in the short run by trends in valuation. People took that 17.6% gain as an encouraging sign, overlooking the fact that it stemmed primarily from the rise of p/e ratios described above and thus was unlikely to continue unabated. Rather than healthy performance that could be extrapolated, this swollen return should have come as a warning that valuations were unsustainable and likely to regress toward the mean. **But investors consistently fail to recognize that past above average returns don't imply future above average returns; rather they've probably borrowed from the future and thus imply below average returns ahead, or even losses.** The tendency on the part of investors toward gullibility rather than skepticism is an important reason why styles go to extremes.

Wharton's Professor Jeremy Siegel, the author of *Stocks for the Long Run*, used historical data (a) to demonstrate that there had never been a long period when stocks didn't outperform cash, bonds and inflation, and thus (b) to argue that most people of average risk tolerance should have roughly 100% of their capital in the stock market. But Siegel, like many laymen, failed to pursue the most critical line of inquiry. **The right question to ask in the late 1990s wasn't, “What has been the normal performance of stocks?” but rather “What has been the normal performance of stocks if purchased when the average p/e ratio is 33?”**

Many investors were seduced by the performance of stocks in the late 1990s by the promise of wealth and a secure retirement, and by the meshing of equity participation with the allure of the technology, media and telecom industries. The results are well known: the first three-year decline for stocks since the Great Depression; a peak-to-trough decline of 51% for the S&P 500; massive losses for tech investors; shrunken 401-k accounts; and general disillusionment with stocks.

Basically, I think equity investors had their hearts broken, as happens from time to time in the investment world. The promise of easy money turned out to be empty – as usual – and investors who had adopted overblown expectations promised “never again.” A good economy, low interest rates and resurgent general psychology brought stocks back between 2002 and 2007, but just to their 2000 peak. Versus the 11% prospective return they were sure of in 1999, by 2003 many investors expected only 6-7% from stocks (despite the fact that they were now much cheaper). With the bloom off the rose, people looked elsewhere – to private equity, real estate, hedge funds and mortgage backed securities, for example – for the next solution. I didn't hear any investors say, “We don't have enough stocks.” Their glory truly had faded.

But having recovered to their previous high, stocks were buffeted again in the credit crisis. They fell 58% from their 2007 peak to their 2009 trough. Stocks weren't singled out for punishment; non-government bonds, real estate, mortgage securities and private equity all shared the pain as panic and loss of confidence were everywhere.

With the panic now gone, stocks have recovered, but only about half their 2007-09 losses. The S&P 500 stands at a level that was first reached in 1998, meaning over the last twelve years, the average stockholder's paltry return of less than a percent a year came entirely from dividends. People talk about the "lost decade in equities," and still no one seems to feel he owns too few stocks.

A Brief History of Bonds

The recent history of bonds requires less telling. Bonds were the bedrock of investment portfolios in the first half of the last century. Along with Treasuries, utilities and corporates, business was brisk in railroad and streetcar bonds. Graham and Dodd's classic, *Security Analysis*, devoted more than 200 pages to "fixed-value investments" including preferred stock, of which next to nothing is heard today.

The story of bonds in the last sixty years is the mirror opposite of what happened to stocks. First bonds wilted as stocks monopolized the spotlight in the 1950s and '60s, and at the end of 1969, First National City Bank's weekly summary of bond data died with the heading "The Last Issue" boxed in black. Bonds were decimated in the high-interest-rate environment of the '70s, and even though interest rates declined steadily during the '80s and '90s, bonds didn't have a prayer of standing up to equities' dramatic gains.

By the time the late 1990s rolled around, any investment in bonds rather than stocks felt like an anchor restraining performance. I chaired the investment committee of a charity and watched as a sister organization in another city – which had suffered for years with an 80:20 bond/stock mix – shifted its allocation to 0:100. I imagined a typical institutional investor saying the following:

We have a little money in bonds. I can't tell you why. It's an historical accident. My predecessor created it, but his reasons are lost in the past. Now our fixed income allocation is under review for reduction.

Even though interest in stocks remained low in the current decade, little money flowed to high grade bonds. The continued decline in bonds' popularity was fed, among other things, by the decision on the part of the Greenspan Fed to keep interest rates low to stimulate the economy and combat exogenous shocks (like the Y2K scare). With Treasuries and high grade bonds yielding 3-4%, they didn't do much for institutional investors trying for 8%.

As a result of a process I consider quite standard, bond allocations reached all-time lows at just the time they became needed. Other than cash and gold, Treasuries were the only asset that performed well in 2008. In fact, they benefited from a massive flight to quality. Corporate high grade and high yield bonds suffered along with everything else in 2008, but less than stocks, and they've enjoyed a comparable recovery. Thus bonds have performed much better than stocks since the onset of the crisis in July 2007, as shown on the next page.

	<u>June 30 to June 30</u>			
	<u>2007-08</u>	<u>2008-09</u>	<u>2009-10</u>	<u>three years</u>
10-year Treasury bond	12.6%	7.3%	8.3%	30.8%
Barclay's Govt/Credit	7.2	5.3	9.7	23.8
Citi High Yield Index	-0.5	-4.2	24.7	18.8
S&P 500	-13.1	-26.2	14.4	-26.6
MS EAFE Index	-22.5	-26.1	7.1	-38.7
MS Emerging Markets	2.6	-30.0	20.6	-13.4

Clearly, the recent performance edge of bonds over stocks has been dramatic.

What's Going On Today?

Now, suddenly, investors seem to have awakened to bonds' attractions. This after failing to do so in time for the crisis, when holding bonds would have been of great value. Is this just another case of investors driving while looking in the rearview mirror? And are they shifting from stocks to bonds at just the wrong time?

The headlines are dramatic and the facts are clear. In just the last few weeks, we've seen newspaper stories like these: "Investors Fleeing Stocks with Cash Flow Lure JP Morgan" (Bloomberg, August 16), "Treasury Bears Cave as Bond Yields Keep Tumbling" (*The Wall Street Journal*, August 16), and "Growing Concern over Bond Bubble" (*Financial Times*, August 21). Bloomberg reported as follows:

About \$33 billion flowed out of funds owning U.S. shares this year . . . About \$185 billion was sent to bond funds through July 31, the most on record, according to the Investment Company Institute.

These statistics relate to mutual funds and their retail investors. While not necessarily the same for institutions, they are indicative of trends in investor psychology. In other words, the disaffection with stocks is continuing, and the withdrawn capital and much more is flowing to bonds. (It must be noted, however, as Tom Petrino of the *Los Angeles Times* pointed out on August 21, that gross inflows to equity mutual funds are still very substantial – and larger than those into bond funds – although exceeded in this period by outflows.)

The first question I want to tackle is "why these trends?" The answer with regard to stocks is simple. They were over-hyped in the 1990s; they disappointed in the 2000s; and investors are extrapolating the poor performance (even at lower prices) just like they previously extrapolated good performance (at higher prices). **This tendency to expect trends to continue is typical of investor behavior, especially with regard to phenomena that should instead be expected to regress toward the mean.**

In the late 1990s, when stocks were performing so well and universally expected to far exceed most investors' return needs, no one saw a reason to hold fixed income instruments with their modest yields. Now stocks have performed poorly for a decade and expectations have been cut back. Equities are no longer considered the sure thing they were. The other day *The New York Times* ran an article entitled "In Striking Shift, Investors Flee Stock Market":

Renewed economic uncertainty is testing American's generation-long love affair with the stock market. . . . Small investors are "losing their appetite for risk." . . . "Like everyone else, I lost" during the recent market declines [an individual investor] said. I needed to have a more conservative allocation." . . . Investors pulled \$19.1 billion from domestic equity funds in May, the largest outflow since the height of the financial crisis in October 2008. (August 22, 2010)

Turning conservative after a crisis smacks of closing the barn door after the horse has left, but it's a regular feature of investor psychology.

Of course, there has to be a fundamental rationale for investor behavior, and the current low opinion of stocks is based on the spreading belief that the recovery will be anemic and there could be a double dip. Also behind it may be the expectation that tax rates on dividends and long-term capital gains will rise relative to the rates on ordinary income.

And why is so much capital flowing to bonds? The analogy to hemlines serves well in this regard. Take a long-established style, stir in changed circumstances, and add a significant swing in psychology. **Bonds became passé over a long period of time, and stocks caught everyone's attention. When these trends had gone as far as they could, and the error of the fashion extreme ultimately was exposed, bonds came back into style.**

Bonds used to constitute the majority of portfolios; then a 70:30 equity/bond mix became the norm; and then bonds went further out of style. And then, when bond allocations got as small as they could, the style mavens began to call for more, instead. Of course it helped that bonds outperformed during and after the crisis.

So few people held bonds going into the crisis, and in such small amounts, that the attractions of bonds must seem like a sudden revelation: They're senior in the capitalization to equities, of course, so they're less subject to fundamental risk. Then there's what I call the "power of the coupon." In addition to redemption at maturity, most bonds provide an interest check every six months. Not only are these cash flows spendable and investable, but they also serve to stabilize bond prices, restraining volatility. Sounds like a great deal. So why, people now wonder, did we hold so few? **Take historically small allocations, add in newly discovered merits, and you get a buying trend and rising prices.**

The fundamental underpinnings for the buying trend in bonds are the converse of those compelling equity reductions: concern about economic sluggishness, the chance for a double dip, and even the distant possibility of deflation. Under any of these circumstances, companies are likely to do poorly, so you'd rather own senior securities (debt) with the promise of positive returns if held to maturity, rather than junior ones (equities), to which just about anything can happen.

And if inflation is declining – taking interest rates with it – you'd rather secure a fixed rate of return with a bond than hold a totally variable instrument like a stock. With inflation at zero or negative, the thinking goes, locking in today's interest rates will prove to have been a godsend.

Finally, if we get back into another crisis, wouldn't we rather hold bonds? Look how well they did during the last one.

At What Price?

That question – at what price? – isn’t just the right question to ask about bonds versus stocks today. It’s the right question regarding every investment at every point in time.

I try every chance I get to convince people that in investing, there’s no such thing as a good idea . . . or a bad idea. Anything can be a good idea at one price and time, and a bad one at another. Here’s how I’ve put it in the past:

It has been demonstrated time and time again that no asset is so good that it can’t become a bad investment if bought at too high a price. And there are few assets so bad that they can’t be a good investment when bought cheap enough. . . No asset class or investment has the birthright of a high return. It’s only attractive if it’s priced right. (“The Most Important Thing,” July 1, 2003)

Investment success doesn't come primarily from "buying good things," but rather from "buying things well" (and the difference isn't just grammatical). (“The Realist’s Creed,” May 31, 2002)

The thing to think about isn’t whether you’d rather have junior or senior securities in a recession, or fixed rate securities versus variable ones in deflation. The question is which securities are priced right for the future possibilities: which ones are priced to give good returns if things work out as expected and not lose a lot if they don’t? You mustn’t fixate on a security’s intrinsic merits, but rather on how it’s priced relative to those merits.

So, for example, it’s not enough to say “We want fixed rate securities in deflationary times.” You’ll be glad to be holding 2½% ten-year Treasuries if deflation materializes, but how will you feel if it doesn’t? And what’s the probability of each outcome?

If bonds are ideal for deflation and stocks will bear the brunt of the associated economic weakness, is that all that matters? Would you rather buy overpriced bonds than underpriced stocks? Is there an objective standard for overpriced and underpriced? And, for example, if the ten-year note will pay 2½% regardless of the environment, and stocks will return 15% if deflation is avoided and lose 10% if it’s not, doesn’t deflation have to have a likelihood exceeding 50% for bonds to be preferred? (Check the math.)

My point here is that simplistic blanket statements are no help at all in making investment decisions. How have investors gotten killed in the past? By falling for statements like these:

- High-growth stocks are a good thing (1970).
- Bonds rated below triple-B aren’t appropriate for investment (1977).
- No one will ever buy equities again (1979).
- There can never be too many disc-drive manufacturers (1988).
- The Internet and optical fiber will change the world (1999).
- Home prices can only go up, and there can’t be a nationwide surge in mortgage defaults (2006).
- High yield bonds are unattractive given the risk of Armageddon (2008).

Most of today’s positive articles about bonds are totally devoid of discussion of prices and probabilities. But it’s only by assessing those things that attractiveness can be determined.

What To Do Now?

Ever since the financial crisis started in mid-2007, I've been saying any recovery would be lackluster and investors shouldn't be planning on prosperity. To me that called for investing in solid, stable, non-cyclical companies; avoiding levered companies and strategies; emphasizing risk-controlled strategies and managers; and, perhaps foremost, holding more bonds and fewer stocks. These were general principles: my own blanket statements, if you will. But now that stock prices have drifted lower and bond prices have continued to surge, I find I must reconsider the emphasis on bonds.

How are bonds priced today? What returns can we expect? Let's consider that 2½% ten-year note. With regard to Treasury securities, where it still seems safe to say there's no credit risk, there are three possible states of nature.

- If we buy at a yield to maturity of 2½% and interest rates don't change, we'll enjoy an annual return of 2½% per year for the next ten years. (With interest rates unchanged, there'll be no change in price other than from accretion to par at maturity, and we'll be able to reinvest the interest payments at the yields available at the time of purchase, an assumption implicit in the yield-to-maturity calculation.)
- If interest rates fall in response to economic weakness or deflation, we're likely to see interim appreciation. And if we sell at the appreciated prices, our holding-period return will exceed the yield to maturity at which we bought. Even if we just hold, our 2½% notes will be desirable museum pieces, as in, "Do you remember the good old days, when you could get 2½% on Treasuries?" (In truth, though, how much lower can yields go from here?).
- Finally, if the economy, inflation and interest rates surprise on the upside relative to today's low expectations, having locked in a yield of 2½% won't turn out to have been a good thing. From 2½%, it's clear that rates have much further to go up than down. Any substantial increase in bond yields would bring meaningful interim price declines. It must be borne in mind that holders of the bonds of creditworthy issuers don't have to worry about permanent capital losses (unless they're frightened into selling when things are down). A bond that's money-good will outlive any negative interim fluctuations, pay par at maturity and deliver the yield at which it was bought. So the real risk for people who invest in these bonds is that their returns turn out to be sub-par under the circumstances. If inflation turns out to be normal, investors in the 2½% note may end up with no more purchasing power down the road than they have today – that is, a real return of zero. Thus, if there are positive surprises in the environment, bond holders are likely to wish they had stocks instead.

Portfolio construction is supposed to strike an appropriate balance between safety and certainty on one hand and aggressiveness and gains-seeking on the other. The key question is whether today's bond buyers are leaning too heavily toward the former and forgetting too much about the latter. Are they too pessimistic and thus honoring uncertainty to excess?

An article by Richard Thaler of the University of Chicago, in *The New York Times* of August 22, makes an important point. He wrote about CFOs, but I think it's largely the same for investors:

... the confidence limits [of their forecasts] widen after bear markets, mostly because estimates at the lower bound become more pessimistic. This puts a new light on the recent comment by Ben S. Bernanke . . . that the economic outlook was "unusually uncertain." . . . Yes, things *feel* more uncertain after bad times,

but severe market downturns tend to occur after long bull markets when we are feeling least uncertain.

In other words, investors become so accustomed to good times that bad times seem unsettling in comparison. **That could explain excessive appetites for the safety of bonds and thus why, according to Deutsche Bank, “the top 10 lowest-yielding U.S. corporate new issues in history have been sold in the last 14 months”** (Bloomberg, August 16).

And what about sellers of stocks? I’m no longer an “equity guy” by profession, and Oaktree manages far more bonds than stocks, so this isn’t a commercial. But I feel investors may be overlooking some substantial merits on the part of stocks today (data from Bloomberg, August 16, except as noted):

- Having made their organizations lean and benefited from declining floating-rate interest costs, cheaper labor or staff downsizing, companies are doing a good job of making money despite today’s lackluster economic environment. “Earnings for S&P 500 companies may rise 36% in 2010 and 16% in 2011, the largest two-year advance since 1994-5.”
- Rather than spend that money on expansion or acquisitions, most companies are piling it up. “The Federal Reserve reported in June that nonfinancial companies were holding cash totaling more than \$1.8 trillion, having built up their hoards at a rate unmatched in more than 50 years” (*LA Times*, August 25). This pile of cash adds greatly to companies’ financial security and to the potential for dividend increases or stock buybacks in the future.
- Finally, those selling or shunning stocks today seem to be overlooking some very attractive valuation parameters.
 - Price/earnings ratios are lower than usual. “The S&P 500 trades at 14.4 times annual earnings, compared with an average of 16.5, according to data . . . that goes back to 1954.” Not giveaway levels, but 13% below the post-war average.
 - Annual free cash flow for American companies excluding banks is running at 6.8% of their market value. This “cash flow yield” is roughly capable of being compared against the yield on bonds. Although (unlike dividends or interest) the cash flow isn’t necessarily received by investors as it’s earned, it should contribute to stocks’ value one way or another.

The bottom line is that, as bond prices rise (reducing yields) and p/e ratios fall, the chances increase that stocks will outperform bonds. Thus the benefits high grade bond investors feel they’re gaining through **what they’re buying** can be undone by **what they’re paying**. I’ll say it another way: **the attractiveness of one investment relative to another doesn’t come from what it’s called or how it’s positioned in the capital structure, but largely from how it’s priced relative to the other.**

I’m impressed today by the ability to assemble a portfolio of iconic, high quality, large-cap U.S. growth stocks that will provide appreciation in a strong environment, a measure of protection in a weak environment, and a meaningful dividend yield regardless. To me, and given my standard view that we don’t know what the macro future holds, these stocks’ potential over a range of possible scenarios is more attractive than bonds which will do well in periods of economic weakness or deflation but poorly in strength or inflation.

Compared to stocks, I feel Treasuries and high grade bonds currently reflect all of the environmental factors in their favor and perhaps more and are priced rich relative to stocks. For them to do well from here, with yields so low, everything has to work out as the bond bulls hope.

My friend, hedge fund manager Doug Kass, publishes a daily note to investors. (Given that I average a memo every couple of months, I find the very idea daunting.) I usually like what he writes, which is another way of saying we think a lot alike. Doug's August 18 note carried a catchy headline, "Setting Up For the Trade of the Decade." His nominee for that sobriquet: shorting the U.S. bond market.

What about high yield bonds, one of Oaktree's flagship asset classes? They're selling at yield spreads over Treasuries that are well above the historic norms, and their promised yields to maturity (before credit losses) should help institutional investors toward their return goals. On the other hand, it must be said that if interest rates rise, high yield bonds will see interim markdowns (albeit cushioned by their modest durations and the "gravitational pull" of price toward par at maturity). In all, given today's yield spreads, we believe high yield bonds will outperform high grade bonds in most foreseeable long-term environments.

Leveraged loans may deserve consideration as well. The yields on these loans are low in the absolute, like other fixed income instruments, but relatively attractive at 5½-6%. The loans are senior-most in the capital structure, meaning they should provide some protection in a sluggish economy, and the fact that their interest rates float with LIBOR should insulate them against interest rate increases.

Oaktree manages half a dozen large "multi-strategy fixed income" accounts, in which we are responsible for allocating capital to our various marketable securities strategies. Recently, in recognition of the developments described above, we made a modest initial shift away from high yield bonds and into convertibles, with their sensitivity to equity market trends. Here's what I wrote to our multi-strategy clients a month ago:

Certainly by the onset of 2000, people believed too much in stocks and thought too little of bonds. Now, a decade later, these things are reversing. As we enjoy our portfolios' performance, we should be alert for a day when bonds will have become too popular and stocks' outcast status will have rendered them too cheap. We can pat ourselves on the back for being in the right asset classes today, but we shouldn't fail to consider what these diverging performance trends can do to tomorrow's returns.

Since few investment trends continue forever, it's usually smarter to expect ultimate regression to the mean rather than growth to the sky. No one should view the great popularity of bonds relative to stocks without reservation.

September 10, 2010

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Memo to: Oaktree Clients

From: Howard Marks

Re: Open and Shut

Mark Twain is described as having said, “History doesn’t repeat itself, but it does rhyme.” Thanks to the tendency of investors to forget lessons and repeat behavior, it sometimes seems there’s no longer a need for me to come up with new ideas for these memos. Rather, all I have to do is recycle components from previous memos, like a builder reusing elements from old houses. I’m willing to try an experiment along those lines for this memo. Here are my building blocks:

From “First Quarter Performance,” April 11, 1991:

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. . . . 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.”

From “The Happy Medium,” July 21, 2004:

The capital market oscillates between wide open and slammed shut. It creates the potential for eventual bargain investments when it provides capital to companies that shouldn’t get it, and it turns that potential into reality when it pulls the rug out from under those companies by refusing them further financing. It always has, and it always will.

From “You Can’t Predict. You Can Prepare.” November 20, 2001:

Overpermissive providers of capital frequently aid and abet financial bubbles. . . . In *Field 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.

From “Genius Isn’t Enough,” October 9, 1998:

Look around the next time there’s a crisis; you’ll probably find a lender.

The above citations provide the themes for this memo. I’ll just update them, put them into the current context and discuss the ramifications for investing today. We’ll see how

it goes. If it works well this time, readers may conclude that in the future they can fashion their own memos from bits and pieces of my old ones.

The Credit Cycle at Work

Consider this: the ups and downs of economies are usually blamed for fluctuations in corporate profits, and fluctuations in profits for the rise and fall of securities markets. However, in recessions and recoveries, economic growth usually deviates from its trendline rate by only a few percentage points. Why, then, do corporate profits increase and decrease so much more? The answer lies in things like financial leverage and operating leverage, which magnify the impact on profits of rising and falling revenues.

And if profits fluctuate this way – more than GDP, but still relatively moderately – why is it that securities markets soar and collapse so dramatically? I attribute this to fluctuations in psychology and, in particular, to the profound influence of psychology on the availability of capital.

In short, whereas economies fluctuate a little and profits a fair bit, the credit window opens wide and then slams shut . . . thus the title of this memo. I believe the credit cycle is the most volatile of the cycles and has the greatest impact. Thus it deserves a great deal of attention.

In “The Happy Medium,” I discussed the workings of the credit cycle in creating market extremes:

Looking for the cause of a market extreme usually requires rewinding the videotape of the credit cycle a few months or years. Most raging bull markets are abetted by an upsurge in the willingness to provide capital, usually imprudently. Likewise, most collapses are preceded by a wholesale refusal to finance certain companies, industries, or the entire gamut of would-be borrowers.

Then, in “You Can’t Predict. You Can Prepare.” I described this expand-and-contract process in detail, along with its ramifications:

- 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 share by lowering demanded returns (e.g., cutting interest rates), lowering credit standards, providing more capital for a given transaction, and easing covenants.

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 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, if anyone.
- 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. . . .

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.

The bottom line is that the willingness of potential providers of capital to make it available on any given day fluctuates violently, with a profound impact on the economy and the markets. There's no doubt that the recent credit crisis was as bad as it was because the credit markets froze up and capital became unavailable other than from governments.

Impact of the Credit Cycle

The section above describes how the capital cycle functions. My goal below is to describe its effect.

From time to time, providers of capital simply turn the spigot on or off – as in so many things, to excess. There are times when anyone can get any amount of capital for any purpose, and times when even the most deserving borrowers can't access reasonable amounts for worthwhile projects. The behavior of the capital markets is a great indicator of where we stand in terms of psychology and a great contributor to the supply of investment bargains. (“The Happy Medium”)

An uptight capital market usually stems from, leads to or connotes things like these:

- Fear of losing money.
- Heightened risk aversion and skepticism.
- Unwillingness to lend and invest regardless of merit.
- Shortages of capital everywhere.
- Economic contraction and difficulty refinancing debt.
- Defaults, bankruptcies and restructurings.
- Low asset prices, high potential returns, low risk and excessive risk premiums.

On the other hand, a generous capital market is usually associated with the following:

- Fear of missing out on profitable opportunities.
- Reduced risk aversion and skepticism (and, accordingly, reduced due diligence).
- Too much money chasing too few deals.
- Willingness to buy securities in increased quantity.
- Willingness to buy securities of reduced quality.
- High asset prices, low prospective returns, high risk and skimpy risk premiums.

The point about the quality of new issue securities in a wide-open capital market deserves particular attention. A decrease in risk aversion and skepticism – and increased focus on making sure opportunities aren't missed rather than on avoiding losses – makes investors open to a greater quantity of issuance. The same factors make investors willing to buy issues of lower quality.

When the credit cycle is in its expansion phase, the statistics on new issuance make clear that investors are buying new issues in greater amounts. But the acceptance of securities of lower quality is a bit more subtle. While there are credit ratings and covenants to look at, it can take effort and inference to understand the significance of these things. In feeding frenzies caused by excess availability of funds, recognizing and resisting this trend seems to be beyond the majority of market participants. This is one of the many reasons why the aftermath of an overly generous capital market includes losses, economic contraction and a subsequent unwillingness to lend.

The bottom line of all of the above is that generous credit markets usually are associated with elevated asset prices and subsequent losses, while credit crunches produce bargain-basement prices and great profit opportunities.

The Events of the Past Decade

The last several years have provided a typical example of the credit cycle at work – typical in its pattern, that is, but unique in its extent and impact.

The highs in risk tolerance, credulity, financial innovation and leverage seen between 2004 and early 2007 gave rise to a credit crunch in late 2007 and 2008 – the

greatest of our lifetimes – and to vast capital destruction. Structured and levered investment vehicles melted down, bringing unprecedented losses to those who had provided their capital, and forcing the sale of holdings regardless of price. Financial institutions flirted with potential insolvency, requiring their capital to be rebuilt via government programs. Money market funds and commercial paper had to be buoyed as well. Lehman Brothers went under. General Motors and Chrysler went bankrupt and required bailouts, and companies such as Fannie Mae, Freddie Mac, Merrill Lynch and Bear Stearns had to be supported or absorbed. All of this stemmed in large part from the too-easy availability of capital and from market participants' irresponsible behavior in the middle of the decade. The result was a massive flight to quality and widespread refusal to take risk.

In 2009, miraculously in my opinion, the responses of governments caused investor psychology to turn positive, and the pursuit of return caused risk tolerance to be restored. Risk capital became available again, enabling financial institutions to raise equity capital and highly indebted companies to access the capital markets, extending maturities and capturing the discounts on their debt. As a result – thanks to the rise in risk appetites – many markets showed their greatest gains ever.

This year, even though economic and geopolitical fundamentals are still shaky and new things to worry about arise from time to time, the credit markets are generally wide open for companies deemed to have critical mass. In “Warning Flags” in May, I observed that certain types of deals could be completed that exemplified behavior in the most heated pre-crisis days but had become impossible in late 2007 and 2008. These included issuance of CCC-rated, covenant-lite and payment-in-kind bonds; dividend recap transactions; and the organization of structured entities for investing in debt.

Recently there have been additions to that list:

- The issuance of 100-year bonds.
- The issuance of 50-year bonds callable in five years (if interest rates go up, the buyer will be stuck with a low-rate bond, but if interest rates go down, the issuer can quickly replace the bond with one bearing a lower rate).
- The issuance of inflation-adjusted Treasury Inflation-Protected Securities (TIPS) that will return minus 0.55% plus the rate of inflation (if there's no inflation, the return will be negative, and if the rate of inflation is positive, the yield on the TIPS will be below that rate).
- The issuance of bonds through so-called “drive-by deals.” When a deal is announced in the afternoon and priced the next morning, investors have little time to study its creditworthiness and covenants.

Each of these things is indicative of the following on the part of investors:

- **rising confidence and declining risk aversion,**
- **emphasis on potential return rather than risk, and**
- **willingness to buy securities of declining quality.**

Why These Developments?

As with any economic event, there are numerous explanations for these things. But the one I want to concentrate on is government stimulus.

In the depths of the credit crisis, governments around the world took steps to deal with the liquidity contraction, economic slowdown and banks' depleted capital accounts. These included reductions of interest rates to record lows. The motivations and effects are many and varied.

First, everyone knows it's the primary goal of rate cuts to stimulate economic activity by making it cheaper and thus more attractive for businesses to borrow money with which to invest in factories, capital good and inventories. Retail credit should be cheaper, too, encouraging consumers to borrow and buy.

Second, providing low cost borrowings is a way to rebuild the health of financial institutions. If a bank can borrow \$100 million from the central bank at 1% and lend it out at 6%, it's as though the government gave it \$5 million per year (assuming the loans turn out to be money-good). Thus, in addition to enhancing banks' profitability and equity, in principle this should lead to increased lending.

To date, the results in these areas have been mixed. Economic activity is still muted and lending is slow. But another by-product has become particularly pronounced: encouragement to take risk.

So third, Treasury bill rates near zero – and note yields of 1 or 2 percent (depending on which country we're talking about) – **have the effect of driving investors toward riskier investments.** Especially when fear and risk aversion recede, returns like these on Treasuries become unacceptable. Thus some money that otherwise would have been invested in the safe part of the fixed income market is forced to more aggressive places.

Whatever fundamental doubt – and resulting reticence – might exist is in part offset by the unacceptably low returns on the safest of investments. Thus, for example, people who wouldn't buy high yield bonds in the past at their traditional 12% yields, or at 20% in 2008, will buy them today at 7% primarily because they can't stomach Treasuries at 2%. In the same way, alternative investment categories that fared poorly in the crisis can attract equity capital again (albeit in smaller amounts and to be paired with less leverage).

The fourth impact is that interest rate declines cause asset appreciation. This restores wealth – household and otherwise – and with it the bullish feelings that give rise to increased willingness to spend money and bear risk.

Fifth, quantitative easing (QE) puts cash in investors' hands in exchange for the securities the Fed buys. This, too, should add to investors' appetite for investing.

However, a program such as QE that increases liquidity has additional consequences. For example, other countries are complaining that (a) excess capital from the low-rate U.S. will flood their markets, inflating asset and commodity prices, and (b) increasing the supply of money in the U.S. will weaken the dollar, unfairly strengthening the appeal of U.S. exports and reducing U.S. demand for imports.

The Ramifications

In 2003, my memo “What’s Going On?” included a tortured metaphor called “The Cat, the Tree, the Carrot and the Stick.” In low-return environments, I said, investors are forced to move further out on the risk curve because of the paltry returns available on safe investments, and lured to riskier investments by the higher returns promised there. Conscious risk bearing can be done responsibly and perhaps even profitably. **But low-return environments often lead investors to unconsciously reach for return, with results that are painful. One of our greatest imperatives is to be alert to the emergence of such behavior.**

A final reference to past memos: you might want to look back to 2004’s “Risk and Return Today.” It describes an investment environment in which rates on short-term Treasuries, reduced by the Fed, had brought down returns in the safe part of the capital market. As a result, I said, the capital market line was “low and flat,” with inflated asset prices, low returns, skimpy risk premiums and high risk. I went on to urge caution when investing in such a low-return environment. It was early, but it turned out to have been in order.

There are differences today. Yield spreads on non-investment grade debt are above average. Leverage is only available in more moderate amounts. With investors chastened by cash squeezes in 2008, the flow of capital to private strategies is limited. Equity p/e ratios are below the historic average. And investors seem to be conscious of the economic and geopolitical uncertainties.

But there are also direct similarities, primarily in the fact that inadequate yields on Treasuries are driving bond investors elsewhere to apply their rekindled risk-taking, and thus absolute yields are low on all fixed income instruments.

On November 12, *The New York Times* reported on comments by Martin Feldstein, former president of the National Bureau of Economic Research and chairman of the Council of Economic Advisers under Ronald Reagan:

Anticipation of QE2, he wrote in the *Financial Times*, caused prices of commodities and common stocks to rise.

“Like all bubbles, these exaggerated increases can rapidly reverse when interest rates return to normal levels,” he said. “The greatest danger will then be to leveraged investors, including individuals who bought these assets with borrowed money and banks that hold long-term securities.

These risks should be clear after the recent crisis driven by the bursting of asset price bubbles. **Although the specific asset prices that are now rising are different from last time, the possibility of damaging declines when bubbles burst is worryingly similar.**” (Emphasis added)

In 2006-07, the most appreciated assets were real estate, mortgages and buyout companies. This year they're Treasury securities around the world, gold, commodities, currencies (versus the U.S. dollar), and real estate and stocks in emerging markets. Buyout companies could return to the list due to the combination of cheap debt, equity capital needing investing, and strong competition to put it to work.

The bottom line is that for whatever the reason, some asset prices have risen again, risk bearing has returned, and the risky transactions of 2004-07 are once again doable. Thus it strikes me that it's time to dust off the ultimate piece of advice from Warren Buffett:

The less prudence with which others conduct their affairs, the greater prudence with which we must conduct our own affairs.

Investors who engaged in aggressive behavior just a few years ago experienced significant pain as a result. Perhaps the punishment was too brief, and perhaps it was reversed too soon. Thus some are acting aggressively once again. It's possible that such behavior won't be punished again the second time around, but prudent investors shouldn't take the risk.

At the depths of the markets in the fourth quarter of 2008, after Lehman Brothers' bankruptcy filing and other events had unnerved the world, great assets were on sale at irrationally low prices. The result – as always in crashes – was that high prospective returns were available with low attendant risk. Just two ingredients were required in order to take advantage: capital and the nerve to invest it.

Today some assets are fairly priced and others are high, but there are no bargains like those of 2008. Capital and nerve can't hold the answers in such an environment. We're no longer in a high-return, low-risk market, especially in light of the inability to know how today's many macro uncertainties will be resolved. **Instead of capital and nerve, then, the indispensable elements are now risk control, selectivity, discernment, discipline and patience.**

December 1, 2010

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Memo to: Oaktree Clients
From: Howard Marks
Re: On Regulation

I've been asked why there weren't any memos during the twelve weeks between September 9 and December 1. Lack of ideas? Writer's block? Carpal tunnel syndrome? CIA posting? The answer is "none of the above." I was putting the finishing touches on a book, *The Most Important Thing: Uncommon Sense for the Thoughtful Investor*. It pulls together all of the strands of my philosophy into what might be thought of as a super-memo. It will be published in late April and I hope you'll let me know what you think.

* * *

In the 3½ years since the financial crisis surfaced in July 2007, there has been extensive discussion of the part deregulation played in creating it, as well as the need for increased regulation to prevent the next one. The release last month of the report of the Financial Crisis Inquiry Commission reawakened the debate. Thus I'm often asked nowadays how I feel about regulation and what I think the future holds in that regard.

The Swing of the Regulatory Pendulum

I've written before that attitudes toward regulation follow the same pendulum-like swing as most other aspects of market behavior. They oscillate not only in response to events in the economic environment, but also because neither total regulation nor total deregulation produces an entirely satisfactory answer. As in so many things, there's no perfect solution.

A great source on the subject is *Wall Street Under Oath*, a 1939 book on the causes of the Great Crash of 1929 written by Ferdinand Pecora, who was counsel to the Senate committee investigating the crash and later a New York State judge. I first read it about twenty years ago, and I brought it out of storage in 2007. It is a typical polemic, assigning blame and touting regulation pursuant to what I assume were the author's philosophical/political biases (see page 4).

Pecora describes a Wall Street that, up to and including the 1920s, was like the Wild West. Bankers and brokers were out to make money for themselves; their behavior was largely unregulated; and conflicts between their interests and those of their clients were widespread and disregarded. In particular, according to Pecora, disclosure standards were non-existent.

These facts combined with other causes to produce a market crash of epic proportions; widespread losses; a drying up of capital; deflation; and a massive depression with a resulting increase in unemployment to 25%. Unsurprisingly, fingers were pointed at the prior administration and political power shifted to believers in an activist role for government. The most lasting result was the enactment of laws that governed the financial system for decades and in many cases still do: the Securities Act, the Securities and Exchange Act, and the Glass-Steagall Act. Thus the 1930s saw a massive swing of the pendulum in favor of regulation.

The next several decades on Wall Street were – perhaps thanks to the impact of those laws – a relatively placid period. This led to a view that, with rare exceptions, market participants are well-behaved by nature. Further, steady growth with only moderate dips caused a perception of an inherently benign and productive economy that could achieve even more if only the regulatory shackles were loosened. After President Carter deregulated the transportation industry in the late 1970s, the door was open for much of the regulatory apparatus built in the early part of the century to be relaxed. Ronald Reagan, whose famously free-market views coincided with a period of peace and prosperity, led the deregulatory charge. We saw a similar turn in Britain under the leadership of Margaret Thatcher; the collapse of the USSR and a resounding victory for capitalism; and the ascendance of free market adherents Alan Greenspan and George W. Bush.

With the economy and financial system generating prosperity, people wanted more of the same. And with manufacturing in decline, we relied heavily on the financial sector for an increased contribution to GDP, job creation and standards of living. The prevailing view was that the less regulation we had, the more productive business and finance could be. And what was there to be feared from an unregulated economy, anyway? The result in the past decade, according to a great newspaper quote that sadly I can't locate, was “the kind of regulation you get from an administration that doesn't believe in regulation.”

Thus, coming full circle from the 1930s, starting in 1999 we saw revocation of Glass-Steagall; elimination of the up-tick rule limiting short sales to instances when stock prices were rising; a pivotal decision to exempt derivatives from regulation; increased permitted leverage at investment banks; and starvation of regulatory agency budgets. These developments were followed by the global financial crisis of 2007-08. Coincidence or causality?

Free Markets Are Dangerous – Regulation is Essential

The free-market, capitalist system runs on self interest and the desire for profit. We need regulation to ensure those things are kept within reasonable limits. Thus the goals of financial regulation are roughly as follows:

- to limit risk, especially risk to the overall financial system,
- to restrict the concentration of economic power,
- to protect customers, especially “the little guy,”
- to prevent error, fraud, misrepresentation and theft, and
- to democratize finance and make it a tool of social policy.

If ethics, self-regulation, personal responsibility, respect for risk and a sense of limits could be counted on, we wouldn't need much in the way of regulation. But, sadly, they can't.

Since the profit motive can lead financial institutions to aggressive risk taking, error and even misdeeds, regulation is counted on to prevent these things. There's also concern that individuals' self-interest might drive them to actions that collectively might injure their companies and society.

Free markets do a great job of allocating economic resources – especially on average over the long run – but the interim fluctuations produced by miscalculation can be intolerable and have to be modulated. This makes regulation indispensable. **Bottom line: the financial system can't be entrusted to untrammelled free markets.**

Regulation is Imperfect and Harmful – Free Markets Do It Best

On the other hand, regulation is too imperfect to be relied on. (Thanks to “Soggy” Sweat for this dialectical approach – see “All that Glitters,” December 17, 2010.) It's easy to write hard-and-fast rules, but rules sometimes impose undue costs or restrict activity in undesirable ways. And their specificity often makes them capable of being circumvented. Because financial institutions are intent on innovation, rules rarely keep pace and regulators usually find themselves playing catch-up. Rule-writing is reactive: rules are written in response to the last problem, not to foresee and prevent the next one, which invariably is different. In addition, regulators lack the financial motivation that drives those who can profit from getting around regulations and exploiting loopholes.

Since rules become outdated and circumvented, it might be preferable to regulate through principles. In other words, rather than numerical limits and defined borders, regulations might be written in general terms to produce adherence to ideals and policy goals. But regulating this way requires that judgments be made, and regulators are rarely accorded the license required for judgment-making. Imagine the second-guessing, legal appeals and phone calls to congressmen that would follow an individual regulator's decision that a financial institution's actions have violated vague principles . . . especially during a halcyon period when the warned-of consequences are slow in coming.

Principle-based regulation requires not only flexibility that is hard to build into and nurture in bureaucracies, but also significant business acumen, perspicacity and foresight. The evidence is *prima facie*: very few people saw the risk posed by sub-prime mortgages and structured mortgage products, and certainly not the regulators. And no one I know of – regulator or otherwise – foresaw the effect these things would have on banks, money market funds and the commercial paper market.

Why didn't regulators say a word about rating agencies' dispensing many thousands of triple-A ratings to structured mortgage vehicles? Why were the highly regulated banks ground zero for the consequences of the financial crisis, while unregulated hedge funds were relatively unscathed? I just can't imagine that regulators will ever have the ability to fully anticipate the consequences of changes in the fast-developing financial system, or to foresee the development

of new problems for which rules and responses have yet to be drawn up. Here's how Peter Sands, chief executive of Standard Chartered, was quoted in the *Financial Times* of January 27: "It is not clear why some regulators who were there before the crisis should believe they now have all the right solutions."

What regulator would have been able to make a difference in protecting our financial institutions (and the overall economy) from the developments of 2004-07? And given how valuable his skills would be in the private sector, how long would he have remained a regulator? No, it just doesn't make sense to expect government employees to safeguard the financial system. **The conclusion is inescapable: responsibility for the safety of the financial system can't be delegated to regulators.**

The Origin of Attitudes

In December I wrote of gold that it's like religion: either you believe in it or you don't. I think something very similar can be said about regulation of business and the economy.

Liberals who champion an expanded role for government tend to be pro-regulation, while conservatives favoring laissez-faire policies and limitations on government will argue against it with vehemence. Democrats generally like an activist government: that's what makes them Democrats. Republicans don't.

Those partaking in the benefits of economic growth tend to favor free-markets and oppose further regulation, since they're happy with things the way they are. The reverse is true for those who are failing to participate and those working in the public sector . . . although there are millions of exceptions on both sides. Businesspeople who trust the economy to perform for them generally oppose regulation, while members of labor want it to prevent their being taken advantage of by management and the owners of capital.

I think our attitudes in this regard are highly correlated with those of our parents and largely a function of the time and place we grew up in. They can be altered through exposure to opposing points of view, but I think most people's attitudes toward regulation stem far more from upbringing and circumstances than from analytical and intellectual processes. Attitudes toward regulation, like politics, are largely hereditary and change slowly if at all.

Reconciling the Two Positions

It's my belief that because both free markets and regulation are imperfect – and because of the strength of people's political and philosophical biases – we will never settle permanently on either a completely free market or a thoroughly regulated system. Any position will prove merely temporary, and the pendulum will continue to swing toward one end of the spectrum and then back toward the other.

- Scandals and crashes will cause a cry for regulation.
- Regulation will curb the excesses and punish the wrongdoers, discouraging repetition.

- The environment will calm, and economic progress will become the rule.
- Memory of the events behind the demand for regulation will fade.
- Free-marketeers will gain sway, and they'll argue that we could do even better if the system were deregulated.
- Regulation will be eased.
- Risk-taking and misdeeds will rise.
- Scandals and crashes will occur anew.
- Pro-regulation forces will regain influence, and free-marketeers will be in the doghouse.
- And the pendulum will swing back toward regulation.

There will never be total, lasting agreement on either complete regulation or totally free markets. **Importantly, however, it might well be the case that compromise between the two has the most dangerous consequences.**

- In the decade leading up to the crisis, politics favored home ownership and liberal mortgage availability. These forces, combined with unregulated mortgage securities markets, gave rise to excessive lending, exaggerated demand for mortgage securities (given the illusion of safety), and thus artificially low mortgage rates and loose terms.
- Which bailout recipients remain the biggest sinkholes, without any real chance of repaying the government's investment? The answer is Fannie Mae and Freddie Mac, the government-created mortgage agencies: supposedly private enterprises whose operations were distorted by a tacit federal guarantee. They engaged in uneconomic behavior, advancing the policy goal of making home ownership available to people who couldn't afford it, and accepting vast risk on the basis of inadequate capital because they (and their lenders) had no fear of loss.
- Legislators turned regulation over to the private sector by putting credit rating agencies in charge of financial institutions' investing standards, giving commercial organizations excessive imprimatur. Financial temptation pressured them to drop their standards, and when they succumbed, the previously sacrosanct triple-A rating became a meaningless label.
- Having witnessed the rescue of the banks and the financial system, we now have a system where free-market rewards will continue to motivate risk taking and no one believes the ultimate price – meltdown – will be demanded of too-big-to-fail institutions that take it too far. A free-market mechanism undercut by moral hazard may perform adequately 95% of the time, but it will pose terrible risks in the remainder.

The real bottom line is that since both free markets and regulation are imperfect, our financial systems will continue to be imperfect. They will work well for us most of the time, although not perfectly, and they will be subject to bubbles and crises every few decades (hopefully not more often).

The Recent Experience

Think about the last few years: the depth of the financial crisis, the pain it caused, the blunders (or worse) that were behind the crisis, the financial sector bailouts it necessitated, and the acrimony they elicited from a Main Street feeling left to fend for itself. Then add in a White House and Congress controlled by Democrats, with their leaning toward government involvement in the economy. Certainly this was a formula for a powerful upswing in regulation.

In this context, I'm surprised that we haven't seen much more government activism. The new financial regulations are mild and constrained, in my opinion. Increases in financial institution capital requirements and controls over executive compensation have generally been more moderate in the U.S. than in Europe. No one has gone to jail (or even been subjected to heavy fines) as in the Enron/Adelphia era. And there have been no punitive increases in taxes on "the rich."

And yet there have been enough steps toward regulation for their limitations to be manifest. One of the primary components of last year's new financial reform law was the so-called Volcker Rule, under which banks can no longer risk their capital on trading and investing for their own account. The bankers I meet with rail against the extent to which this will interfere with their ability to serve their customers and lay off risk. They further complain that actions inherent in market-making can be hard to distinguish from Volcker Rule violations. Where do positions held for trading and hedging stop and prop trading start? Think about Goldman Sachs's bets against subprime mortgages:

- Did they hedge Goldman's long positions in mortgages?
- Did they lessen the risk in Goldman's overall portfolio?
- Were they bets against Goldman's clients?
- Or did they enable Goldman to take positions that served its clients and otherwise engage in client facilitation?

I'd guess the answer is "all of the above." Clearly, however, a market maker can do far more to provide liquidity if it is allowed to hedge through offsetting positions.

Mortgage shorts also shored up Goldman's finances and made it one of the least needy financial institutions. Which would we like to have more of, Goldman Sachs or Lehman Brothers, which plunged into mortgages and derivatives without significant risk control and consequently went bankrupt? And yet Goldman's actions have been vilified and proprietary investing has been outlawed.

On February 6, a front-page *New York Times* story indicated how difficult it is to rein in free-market forces and self-interest. Although Washington pushed financial institutions to compensate executives through stock grants in order to align interests with shareholders (and mandated it at the very top), the article described non-mandated employees' success in hedging their shareholdings and thus sidestepping exposure to the risks affecting their companies.

“Wall Street is saying it is reforming itself by granting stock to executives and exposing them to the long-term risk of that investment,” said Lynn E. Turner, a former chief accountant at the Securities and Exchange Commission. “Hedging the risk can substantially undo that reform. . . .”

More broadly, critics say, the practice of hedging represents another end run around financial reform.

For example, new rules that cracked down on debit card fees have led several big banks to eliminate free checking. Firms also plan to make up missing revenue by adapting their businesses to the tougher new regulations on derivatives and trading with the banks’ own capital.

The *Wall Street Journal* of February 18 provided another example:

In November, Barclays PLC quietly changed the legal classification of the U.K. bank’s main subsidiary in the U.S. so that the unit would no longer be subject to federal bank capital requirements. . . .

The maneuver allows them to escape a provision of the financial-overhaul law that forces the pumping of billions of dollars of new capital into the U.S. entities, known as bank-holding companies.

“It’s just not worth it to have all that capital trapped” in the holding company, said a New York lawyer who is advising banks on how to restructure.

The moves are the latest example of how banks are scrambling to cushion the impact of new laws and rules around the world.

The article went on to illustrate how a patchwork system can be evaded through regulator-shopping. By deregistering its subsidiary as a bank-holding company, Barclays escaped regulation by the Federal Reserve Bank, which would insist on greater capital. Instead its units now fall under the FDIC and the SEC, which will impose no such requirement.

The bottom line as far as I’m concerned is that you can enact a law or rule and tell businesspeople precisely what to do, but you can’t make the economy or companies comply with policies and social aims. Regulations are limited in their scope and effect, and like a balloon, when you push in one place, self-interested behavior pops out in another. As these articles indicate, **those who enact regulation sometimes get it right at first glance, but they’re rarely able to anticipate and control the response of those being regulated or the second-order consequences of the rules.**

Errors and misdeeds will occur as long as imperfect, self-interested humans stray into excessive risk-taking. And as long as these things lead to bubbles and resulting crashes, the willingness to dispense with regulation and rely on free markets will never be complete, regardless of regulation's limitations.

* * *

I believe a free market is the best decision maker, causing financial resources, labor and intellectual capital to flow where they are most valuable and thus have the potential to be best rewarded. But the ride will be bumpy – by necessity – and some of society's goals will go unfulfilled. Of course, those who favor limits on government involvement in business argue that financial and market regulation shouldn't be a vehicle for implementing social policy.

The collapse of the USSR shows the limits of a thoroughly controlled economy. On the other hand, it's likely that China's impressive accomplishments over the last decade have been aided by the fact that its economy is controlled, such that the movement of resources can be centrally mandated in the short run. China's purposefulness is impressive, and China likely would have accomplished less if it had to work entirely through free-market forces. Would we trade our system (and results) for theirs? Will our answer be the same in twenty years? And will China remain the same, or once the highly regulated system has raised standards of living, will people insist on freer markets as well?

The debate will inevitably go on:

- What system is most likely to produce the results we seek? In the last few years we've seen calls for regulations to require "prudent" mortgage lending and prevent "excessive" compensation. What system is best able to define these amorphous terms and produce these results?
- How will economic goals be integrated and balanced with society's other priorities, and should they be?
- How will laissez-faire economics and financial regulation coexist, and what will be the consequences?

These questions will never be answered conclusively. The swing of the pendulum will continue unabated.

March 2, 2011

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Memo to: Oaktree Clients
From: Howard Marks
Re: How Quickly They Forget

In January 2004 I received a letter from Warren Buffett (how's that for name dropping?) in which he wrote, "I've commented about junk bonds that last year's weeds have become this year's flowers. I liked them better when they were weeds."

Warren's phrasings are always the clearest, catchiest and most on-target, and I thought this Buffettism captured the thought particularly well. Thus for Oaktree's 2004 investor conference we used the phrase "Yesterday's Weeds . . . Today's Flowers" as the title of a slide depicting the snapback of high yield bonds. It showed the 45% average yield at which a sample of ten bonds could have been bought during the Enron-plus-telecom meltdown of 2002 and the 6% average yield at which they could have been sold in 2003; **on average, the yields had fallen by 87% in just thirteen months.** The idea went full-circle in 2005, when Warren used our slide at the Berkshire Hathaway annual meeting to illustrate how rapidly things can change in the world of investing.

And that's the point of this memo. Asset prices fluctuate much more than fundamentals. This happens because, rather than applying moderation and balancing greed against fear, euphoria against depression, and risk tolerance against risk aversion, investors tend to oscillate wildly between the extremes. They apply optimism when things are going well in the world (elevating prices beyond reason) and pessimism when things are going poorly (depressing prices unreasonably). Shortness of memory plays a major part in abetting these swings. If investors remembered past bubbles and busts and their causes, and learned from them, the swings would moderate. But, in short, they don't. And they may be forgetting again.

High yield bonds and many other investment media have once again gone from being weeds to flowers – from pariahs to market darlings – and it happened in a startlingly short period of time. As is so often the case, things that investors wouldn't touch in the depths of the crisis in late 2008 now strike them as good buys at twice the price. The swing of this pendulum recurs regularly and creates some of the greatest opportunities to lose or gain. Thus we must always be mindful.

The Importance – and Shortcomings – of Investment Memory

A number of my favorite quotations are on the subject of history and memory, and I've used them all in past memos. Humorist and author Mark Twain talked about the relevance of the past:

History doesn't repeat itself, but it does rhyme.

The philosopher Santayana stressed the penalty for failing to attach sufficient importance to history:

Those who cannot remember the past are condemned to repeat it.

And economist John Kenneth Galbraith described the shabby way investors treat history and those who consider it important:

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.

String together these three pearls of wisdom and you get a pretty accurate picture of investment reality. **Past patterns tend to recur. If you ignore that fact, you're likely to fall prey to those patterns rather than benefit from them. But when markets get cooking, the lessons of the past are readily dismissed.** These are nothing short of eternal verities, and their collective message is indispensable.

Why Does Investment Memory Fail?

Think back to the emotions you felt so strongly during the recent financial crisis, and the terrifying events that brought them on. You swore at the time that you'd never forget, and yet their memory has receded and nowadays has relatively little influence on your decisions. Why does the collective memory of investment experiences – and especially the unpleasant ones – fade so thoroughly? There are a number of reasons.

- **First, there's investor demographics.** When the stock market declined for three straight years in 2000-02, for example, it had been almost seventy years since that had last happened in the Great Depression. Clearly, very few investors who were old enough to experience the first such episode were around for the second.

For another example, I believe a prime contributor to the powerful equity bull market of the 1990s and its culmination in the tech bubble of 1999 was the fact that in the quarter century from 1975 through 1999, the S&P 500 saw only three minor annual

declines: 6.4% in 1977, 4.2% in 1981, and 2.8% in 1990. In order to have experienced a bear market, an investor had to have been in the industry by 1974, when the index lost 24.3%, but the vast majority of 1999's investment professionals doubtless had less than the requisite 26 years of experience and thus had never seen stocks suffer a decline of real consequence.

- **Second, the human mind seems to be very good at suppressing unpleasant memories.** This is unfortunate, because unpleasant experiences are the source of the most important lessons. When I was in army basic training, I was sure the memories would remain vivid and provide material for a great book. Two months later they had disappeared. After the fact, we may remember intellectually but not emotionally: that is, the facts but not their impact.
- **Finally, the important lessons of the past have to fight an uphill battle against human nature, and especially greed.** Memories of crises tell us to apply prudence, patience, moderation and conservatism. But these things seem decidedly outdated when the market's in a bull phase and risk bearing is paying off, and if practiced they appear to yield nothing but opportunity costs.

Charlie Munger contributed a great quote to my recent book, from Demosthenes: "Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true." **In other words, there's a powerful tendency to believe that which could make one rich if it were true.**

I've tried to spend the last 42 years with my eyes open and my memory engaged. As a result, a lot of what I write is based on recognition of past patterns. It's time to put my recollections to work, because I'm definitely seeing a trend in the direction of Galbraith's "same or closely similar circumstances."

The Not-So-Distant Past

It seems it was impossible – unless you were John Paulson – to escape entirely unscathed from the financial crisis of 2007-08. Most investors could only hope to have turned cautious in the run-up to the crisis, sold assets, increased the defensiveness of their remaining holdings, reduced or eschewed leverage, and secured capital with which to buy at the bottom in order to benefit from the subsequent recovery.

What might have prompted investors to do these things in advance of the mid-2007 onset of the crisis? Almost no one fully foresaw the impending subprime meltdown, and few macro-forecasts and market analyses were sufficiently pessimistic. Rather, I think investors would have been most likely to take the appropriate actions if they were aware of the pro-risk behavior taking place around them.

One of the most important things we can do is take note of other investors' attitudes and behavior regarding risk. Fear, worry, skepticism and risk aversion are the things that keep the market at equilibrium and prospective returns fair. When investors fear loss appropriately, too-risky deals can't get done, and risky investments are required to offer high prospective returns and generous risk premiums. (And when fear reaches extreme levels during crises, the capital markets turn too stingy, asset prices sink too low, and potential returns become excessive.)

But when investors don't fear sufficiently – when they're risk tolerant rather than risk averse – they let down their guard, surrender their discipline, accept rosy projections, enter into unwise deals, and settle for too little in the way of prospective returns and risk premiums.

The years immediately preceding the onset of the crisis in mid-2007 constituted nothing short of a "silly season." It seemed the financial world had gone crazy, with deals getting done that were beyond reason. Investors acted as if risk had been banished. They believed that the markets had been rendered safe by the combination of (a) an omniscient, omnipotent Fed providing a "Greenspan put," (b) the wonders of securitization, tranching and selling onward and (c) the "wall of liquidity" coming toward our markets, composed of excess reserves being recycled by China and the oil-producing nations. They accepted the alchemy under which financial engineering could turn sub-prime mortgages into triple-A debt. And they viewed leverage as sure to have a salutary effect on returns.

There's nothing more risky than a widespread belief that there's no risk . . . but that's what characterized the investment world. It was possible to conclude in 2005-07 that investors were applying insufficient risk aversion and thus engaging in risky behavior, elevating asset prices, reducing prospective returns, and raising risk levels. What were the signs?

- The issuance of non-investment grade debt was at record levels.
- An unusually high percentage of the issuance was rated triple-C, something that's not possible when attitudes toward risk are sober.
- "Dividend recaps" went unquestioned, with buyout companies borrowing money with which to pay dividends, vastly increasing their leverage and reducing their ability to get through tough times.
- Credit instruments were increasingly marked by few or no covenants to protect lenders from managements' machinations, and by interest payments that could be made with debt rather than cash at the companies' discretion.
- Collateralized loan and debt obligations were accepted as being respectable instruments – with the risk made to vanish – despite the questionable underlying assets.
- Buyouts of larger and larger companies were done at increasing valuation multiples, with rising debt ratios and shrinking equity contributions, and despite the fact that the target companies were increasingly cyclical.

- Despite all of these indications of falling credit standards and rising riskiness, the yield spread between high yield bonds and Treasury notes shrank to record lows.
- The generous capital market conditions and low cost of capital for borrowers caused buyout fund managers to describe the period as “the golden age of private equity.” Conversely, then, for lenders it was the pits.

In 2005-07, investors suspended skepticism and disbelief, ignored the risk of loss, and obsessed instead about avoiding the risk of missing opportunities. This caused them to buy securities at low implied returns; employ vast amounts of low-cost debt to lever up those returns; loosen the terms on debt they would provide; and participate in black-box vehicles on the basis of investment banks’ recommendations, the nontransparent machinations of financial engineers, and the imprimatur of far-from-perfect rating agencies.

In short, investors were oblivious to risk and thus failed to demand adequate risk premiums. The environment could only be described as euphoric. Here’s how I put it in “It Is What It Is” (March 2006):

The skinniness of today’s risk premiums can be observed most clearly in the high yield bond market, where prospective returns can be calculated with precision and yield spreads are in the vicinity of historic lows, and in certain real estate markets, where actual cash returns are similarly low. But the difficulty of quantifying prospective returns in public and private equity doesn’t mean the offerings there are any less paltry. And, as Alan Greenspan said, “. . . **history has not dealt kindly with the aftermath of protracted periods of low risk premiums.**”

Market Conditions Today

In May 2005, I wrote a memo entitled “There They Go Again,” complaining that investors were taking excessive comfort from mindless platitude of the type that accompany and abet the creation of every bubble. These are accepted as a substitute for putting rational intrinsic valuations on the assets that are the subject of the bubble, and despite repeated evidence that trees can’t grow to the sky. I touched on the mania for real estate, as well as the growing popularity of hedge funds and private equity. I went on to assert that this behavior – and the supportive underlying capital market trends – had turned the markets into a “low-return world.”

I recite all of this because I have no doubt that investors are making substantial movement back in the same direction. To illustrate, here’s an account of capital market conditions in 2011 (*Bridgewater Daily Observations*, February 15):

Consistent with the pickup in credit creation that we have seen elsewhere, LBO activity and the credit pipes that are supporting it have recently improved. Since the first quarter of 2010 we have seen a steady rise in LBO activity, starting from a very

low base. The rate of activity is now roughly similar to the average level of activity since 1985, excluding the boom and bust period of 2006 to 2009. . . . today's deals are similar in size but the number of deals has risen by more than the dollar value of deals. We also see that the leverage in the deals is increasing. For example, so far this year the average deal was financed with 30% equity, down from last year's 38%, though still up from the most leveraged period of 2005 to 2009 when deals were financed with an average of 25% equity. The leveraged loan market has also picked up and an increasing percentage of leveraged loans are going toward LBOs. A few new CLOs and mutual funds have been created that are concentrated on the leveraged loan market, indicative of renewed demand. Investor demand has pushed prices back up to par and allowed a decline in the average credit quality of the loans, with increasing indications of "covenant light" loans getting done.

In other words, in most regards the capital markets – and investors' tolerance of risk – are retracing their steps back in the direction of the bubble-ish pre-crisis years. Low yields, declining yield spreads, rising leverage ratios, payment-in-kind bonds, covenant-lite debt, increasing levels of LBO activity and the beginnings of the return of levered, structured vehicles . . . all of these are available for the eye to see.

For a case in point, let me recap a note I received from one of our veteran high yield bond analysts regarding a deal that recently had come to market:

- PIK/toggle bonds: the company can elect to pay interest in debt rather than cash
- Holdco obligation: debt of a holding company, removed from the moneymaking assets
- Use of proceeds: to pay a dividend to the equity sponsor, returning half of the equity it put into the company just a few months earlier
- The sponsor's purchase price for the company in 2010 was 1.45 times what the seller had bought it for in 2008
- The company operates in a commodity industry where annual sales are shrinking and costs are variable and unpredictable
- Negative earnings comparisons are expected, since the environment makes it hard to pass on rising raw material costs
- EBITDA coverage of interest expense plus capital expenditures is modestly above 1x
- The company is incorporated in Luxembourg, an uncertain bankruptcy environment
- The assessment of Oaktree's Sheldon Stone: "I know they don't ring a bell at the top, but they should on this deal!"

It's easy to gauge bond investors' attitudes. Here are the yield to maturity and yield spread versus Treasurys on the average high yield bond at a few points in the recent past and today:

	<u>Yield to Maturity</u>	<u>Spread vs. Treasurys</u>
“Normal” – December 31, 2003	8.2%	443 b.p.
Bubble peak – June 30, 2007	7.6	242
Panic trough – December 31, 2008	19.6	1,773
Recovered – March 31, 2010	9.0	666
Shrinking again – April 30, 2011	7.5	492

The yield spread on the average high yield bond is still on the generous side relative to the 30-year norm of 350-550 basis points, a range of spreads that has given rise to excellent relative returns over that period. On the other hand, (a) spreads have fallen back to the normal range from the crisis-induced stratosphere and (b) the lowness of today's interest rates means that reasonable spreads translate into promised returns that are low in the absolute. The story's the same for many asset classes.

I don't mean to pick on high yield bonds. I use them here as my prime example only because of my familiarity with them and because their fixed-income status facilitates quantification of attitudes toward risk. In fact, high yield bonds still deliver above average risk compensation, and they remain the highest returning contractual instruments and excellent diversifiers versus high grade bonds.

If you refer back to a memo called “Risk and Return Today” (November 2004), you'll see that today's expected returns and risk premiums – especially on the left-hand side of the risk/return spectrum – are eerily similar to those prevailing in late 2004: money market at 1%; 5-year Treasurys at 3%; high grade bonds at 5%; high yield bonds at 7%; stocks expected to return 6-7%. I said at the time that low base interest rates and moderate demanded risk premiums had combined to render the risk/return curve “low and flat.” In other words, absolute prospective returns were at modest levels, as were the return increments that could be expected for taking on incremental risk. I described that environment as “a low-return world.” I think we're largely back there.

(Please note that late 2004 was nowhere near the cyclical peak. Security prices continued to rise and prospective returns to fall for two and a half years thereafter. In particular, in the 30 months following the publication of that memo, high yield bonds went on to return a total of 19.7%. So similarities to 2004 don't constitute a sign of impending doom, but perhaps a foreshadowing of a potential move into bubble territory.)

I want to state very clearly that I do not believe security prices have returned to the 2006-07 peaks. It doesn't feel like the silly season is back in full. Investors aren't euphoric. Rather they seem like what my late father-in-law used to call “handcuff

volunteers” – people who do things because they have no choice. They’re also not oblivious to the risks that exist. I imagine the typical investor as saying, “I’m not happy, but I have to buy it.” Finally, the leverage used at the peak of risk-prone pursuit of return in 2005-07 isn’t nearly as prevalent today, perhaps because investors are chastened, but more likely because it’s not available in the same amounts.

There may be corners of the market where elevated popularity and enthusiastic buying have caused prices to move beyond reason: high-tech stocks, social networks, emerging markets from time to time, perhaps gold and other commodities (what’s the reasonable price for a non-cash-flow-producing asset?) But for the most part, I think investors are taking the least risk they can while assembling portfolios that they think can achieve their needed returns or actuarial assumptions.

In general, I would describe most security prices as falling somewhere between fair and full. Not necessarily bubbly, but also not cheap.

Especially since the publication of my book, people have been asking me for the secret to risk control. “Okay, I’ll read the 180 pages. But what’s really the most important thing?” **If I had to identify a single key to consistently successful investing, I’d say it’s “cheapness.”** Buying at low prices relative to intrinsic value (rigorously and conservatively derived) holds the key to earning dependably high returns, limiting risk and minimizing losses. It’s not the only thing that matters – obviously – but it’s something for which there is no substitute. Without doing the above, “investing” moves closer to “speculating,” a much less dependable activity. When investors are serene or even euphoric, rather than discomforted, prices rise and we become less likely to find the bargains we want.

So if you could ask just one question regarding an individual security, asset class or market, it should be “is it cheap?” Oaktree’s investment professionals try to ask it, in different ways, every day.

And what makes for cheapness? In sum, the attitudes and behavior of others.

I try to get away from it, but I can’t. The quote I return to most often in these memos, even 17 years after the first time, is another from Warren Buffett: “The less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs.” When others are paralyzed by fear, we can be aggressive. But when others are unafraid, we should tread with the utmost caution. **Other people’s fearlessness invariably translates into inflated prices, depressed potential returns and elevated risk.**

Today, pension funds and endowments simply can’t achieve their goal of nominal returns in the vicinity of eight percent if they keep much money in Treasuries or high grade bonds, and they may not even expect public equities to be much help. They’ve moved into high yield bonds, private equity and hedge funds . . . not because they want to, but

because they feel they have to. They just can't settle for the returns available on more traditional investments. Thus their risk taking is in large part involuntary and perhaps unenthusiastic.

So where do we stand today?

- General interest rates are some of the lowest in history.
- Yield spreads are about normal.
- Returns on low-risk assets are reasonable in relative terms but skimpy in the absolute.
- Investors are forced toward pro-risk behavior because of the lowness of returns in the safer, low-risk portion of the risk/return curve.
- Thus investors are jettisoning the conservatism they adopted at the depths of the financial crisis, in many cases not out of choice.
- Investors are once again engaging in risky behavior, albeit not at peak levels of riskiness.

Those of us who calibrate our behavior based on what others are doing should increase watchfulness and, as Buffett suggests, apply rising amounts of prudence.

How Did Things Get This Way?

Just two and a half years ago, in the depths of the financial crisis, I was convinced that pro-risk psychology had undergone lasting damage. With investment banks, rating agencies and financial engineers defrocked, no-lose investments collapsing, account balances decimated and investors disillusioned, it seemed it might be years before market psychology recovered. And yet markets began a dramatic recovery in early 2009, investors have returned to bearing risk, and many indices are back in the vicinity of their pre-crisis peaks. What's behind this turn of events?

In 2007 and 2008, governments around the world rushed to support financial institutions and stimulate economies. They did this by making liquidity readily available and cutting interest rates to near zero.

Everyone knew the rate cuts would stimulate the economy by encouraging borrowing and reducing the cost of doing business, and that they would increase the profit margin in lending, buttressing financial institutions. But I don't think anyone fully appreciated the impact they would have on reviving pro-risk behavior.

In short, the rate cuts made it unrewarding to hold cash, T-bills and high grade bonds. Investors looking for returns in line with their needs – or income on which to live – were literally forced to move into riskier asset classes in pursuit of returns in excess of a few percent.

Much of the money that normally would be invested in the giant Treasury market simply couldn't stay there because the yields were so low. Thus large amounts flowed toward smaller markets where they were quite capable of lifting prices. Nothing can reduce returns, worsen terms or raise risk faster than "too much money chasing too few deals." **It's disproportionate flows of capital into a market that give rise to the disastrous race to the bottom such as we saw in 2005-07. Greater sums are provided to weaker borrowers at lower interest rates and with looser terms. Higher prices are paid for assets: first less of a discount from intrinsic value, then the full intrinsic value, and eventually premiums above intrinsic value.** These processes account for many of the trends decried here.

In addition, I would point out that the pain of the crisis was surprisingly short-lived. The real panic began on September 15, 2008, the day Lehman Brothers filed for bankruptcy. Until then, the world seemed to be coping and investors retained their equanimity. But Lehman, Fannie Mae, Freddie Mac, Merrill Lynch, Washington Mutual and AIG fell like dominoes in short order, and in the last fifteen weeks of 2008 people were paralyzed by fear of a global financial meltdown.

And then things turned in the first quarter of 2009, primarily, I think, because people were coerced to move further out on the risk curve as described above. Since then the markets have risen dramatically from their lows.

In distressed debt, for example, the post-Lehman days and weeks were characterized by terror, uncertainty, forced selling, illiquidity and huge mark-to-market losses. But if you look back, you see that the panic and pain – and thus the greatest buying opportunity – really lasted only fifteen weeks, through the end of 2008. Prices continued downward in the first quarter of 2009, but without the deluge of supply brought on by the previous quarter's forced selling. By April prices were headed up. So the lesson was painful but short-lived and, apparently, easily forgotten.

As usual, the cyclical upswing is circular and self-reinforcing. It takes on the appearance of a virtuous cycle that will proceed non-stop, and it does so . . . until it fails. Here's an example of the process at work:

- The pursuit of return caused people to move from Treasuries to high yield bonds.
- The revival of demand enabled companies to raise money.
- The reopening of the capital markets made it possible for companies to do bond exchanges and refinancings: extending maturities, extinguishing covenants and capturing bond discounts, converting them into reduced amounts of debt outstanding. In some cases equity could be issued to delever balance sheets.
- These remedial actions improved companies' creditworthiness and brought down the default rate on high yield bonds from 10.8% in 2009 to a startling 1.1% in 2010, the greatest one-year decline in history.

- The resulting price appreciation produced profits for those who'd bought, turning investor psychology more rosy and producing envy – and thus a rush to join in – among those who had been slow to invest.
- And the combination of these things convinced people that conditions had improved, making them still more willing to take on increased risk.

I thought the lessons of 2007-08 had been etched into people's psyches, and that the return to pro-risk behavior would therefore be slow. But clearly that hasn't been the case.

Prudent Behavior in a Low-Return World

The 2005 memo I mentioned earlier, "There They Go Again," proceeded from the discussion of the low and flat risk/return curve contained in "Risk and Return Today" to ponder what investors might do in times of low prospective returns and risk premiums. The possibilities fell into just a few categories:

- Go to cash – not a real alternative for most investors.
- Ignore the lowness of absolute returns and pursue the best relative returns.
- Forget that elevated prices might imply a correction, and buy for the long run.
- Reach for return, going out further on the risk curve in pursuit of returns that used to be available with greater safety.
- Concentrate investments in "special niches and special people"; by this I meant emphasizing strategies offering exceptional bargains and managers with enough skill to wring value-added returns from assets of moderate riskiness.

Of all of these, I consider reaching for return to be the most flawed, especially if it's done without being fully conscious (which is often the case when return becomes hard to come by). I've described this approach as "insisting on achieving high returns in a low-return world" and reminded people of Peter Bernstein's admonition: "The market's not a very accommodating machine; it won't provide high returns just because you need them."

Here's what I wrote in May 2005:

Given today's paucity of prospective return at the low-risk end of the spectrum and the solutions being ballyhooed at the high-risk end, many investors are moving capital to riskier (or at least less traditional) investments. But (a) they're making those riskier investments just when the prospective returns on those investments are the lowest they've ever been; (b) they're accepting return increments for stepping up in risk that are as slim as they've ever been; and (c) they're signing up today for things they turned down (or did less of) in the past, when the prospective returns were much higher. This may be exactly the wrong time to add to risk in pursuit of more return. You want to take risk when others are fleeing from it, not when they're competing with you to do so.

Even six years later, I can't think of any responses to a low-return world beyond those enumerated above. Limit risk, sacrificing return. Accept risk in pursuit of return, and pray the consequences will be tolerable. Or strive to find ways to augment returns through means other than risk bearing.

None of these possible solutions is perfect and without pitfalls. In fact, each brings its own form of risk. Staying safe entails the risk of inadequate return. Reaching for return increases the risk of financial loss. And the search for "alpha" managers introduces the risk of choosing the wrong ones. But, as they say, "it is what it is." When it's a low-return world, there are no easy solutions devoid of downside.

The Right Approach for Today

One of the things that makes investing interesting is the ever-changing nature of the route to profit, the pitfalls that are present, and the tools and approaches that should be employed. Conscious decisions regarding these things should underlie all efforts to manage capital, and they must be revisited constantly as circumstances and asset prices change. What's right today?

First, should you prepare for prosperity or not? By prosperity I mean a return to the happy days of the 1980s and '90s, when reported economic growth was strong and consumers were eager to spend. My answer is that we're not likely to see anything like that, in large part because in those decades the gap between stagnant incomes and vigorous consumption growth was bridged through buying on credit. Instead, in the years ahead I think (a) growth in employment and incomes will be sluggish, (b) consumers should be restrained in their borrowing as a result of having experienced the crisis, (c) consumer credit shouldn't be available as readily, and (d) borrowing against home equity will be much less of a factor, especially because home equity is so scarce.

Second, should you worry more about losing money or about missing opportunities? This one's easy for me. First, the macro uncertainties tell me we won't be seeing a highly effervescent economy or market environment. Second, other people's increasingly aggressive behavior tells me to seek cover. And third, since I don't see many compellingly cheap assets, I doubt there will be gains big enough to make us kick ourselves for having invested too cautiously.

And that brings me to my third question: what tools should you employ? In late 2008 and early 2009, you needed just two things to achieve big profits: money to commit and the nerve to commit it. If you had caution, conservatism, risk control, discipline and selectivity, you probably achieved lower returns than otherwise (although having factored those things into your analysis might have given you the confidence needed to implement favorable conclusions in that terrible environment). The short answer was simple: money and nerve.

But what if you had money and nerve in 2006 or early 2007? The results would have been disastrous. In those times you needed caution, conservatism, risk control, discipline and selectivity to stay out of trouble. **In short, when the market is defaulting on its job of being a disciplinarian, discernment becomes our individual responsibility.**

So then, which is the right set of equipment for today? I think we're back to needing the cautious attributes, not the aggressive. An unusually large number of thorny macro issues are outstanding, including:

- the so-so U.S. recovery;
- the U.S.'s deficit, debt ceiling impasse and dysfunctional political process;
- the economic impact of deleveraging and austerity;
- the over-indebtedness of peripheral eurozone countries;
- the possibility of rekindled inflation and rising interest rates;
- the uncertain outlook for the dollar, euro and sterling; and
- the instability in the Middle East and resulting uncertainty over the price of oil.

With all of these, plus prices that are fair to full and investor behavior that has increased in aggressiveness, I would rather gird for the things that can go wrong than ensure maximum participation if things go right. (Of course that's not an unfamiliar refrain from me.)

The other day, the investment committee of a non-profit on which I sit decided to take the first steps toward marshaling resources and managers so as to be ready to buy into beaten-down assets after the next round of bubble and bust. And it wasn't even my idea!

We can never be sure what will happen – and certainly not when – but it's important to be prepared for what's likely to lie ahead. And understanding the inevitable pendulum swing in the way investments are viewed – from weeds to flowers and back – is an essential ingredient in being able to do so.

May 25, 2011

P.s.: I hope you'll consider rereading "Risk and Return Today" (November 2004) and "There They Go Again" (May 2005) (see <http://www.oaktreecapital.com>). Hopefully they'll strengthen the case for reflecting on past patterns and help you think through the current conditions. You might also take a look at "The Cat, the Tree, the Carrot and the Stick" in "What's Going On" (May 2003) for a metaphorical look at the process of risk acceptance. Today's echoes of those past times are worth noting.

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Memo to: Oaktree Clients
From: Howard Marks
Re: Down to the Wire

Here are the ingredients in the plot: A problem everyone's aware of. If it isn't resolved, a shutdown with unspecified but possibly disastrous consequences. A deadline which seems indispensable, since in its absence it appears nothing would be done. And despite the presence of the oncoming freight train, movement toward a solution is deterred by highly entrenched positions. It's truly white-knuckle time, and if the progress toward a solution continues to lag, the things that must happen won't.

I'm not talking about the nearly concluded drama at the National Football League, where failure to reach a labor settlement for just a few more days would have caused significant changes in the schedule for the coming year, upsetting the flow of wealth to owners and players and depriving fans of the game they love. I'm talking about the down-to-the-wire battle over the U.S. debt ceiling. I've decided to devote a memo to the debt issue and its significance. I especially hope it'll be helpful to our non-U.S. clients, for whom the lack of progress to date must be absolutely incomprehensible.

Interestingly, the immediate debt crisis is somewhat artificial. It is occasioned now only because of our debt ceiling, which currently limits the net debt of the United States to \$14.29 trillion. Such ceilings are far from the norm worldwide. Many other nations seem to function no worse without them.

But the U.S. has the historical accident of a ceiling, and we must deal with it. Because the limitation is set in terms of absolute dollars and not indexed for inflation or growth, we would run into it every few years even if our debt only grew apace with the economy. "In fact, it's been raised nearly 100 times over the decades." (*Financial Times*, July 16) But thanks to the especially rapid growth of our debt relative to GDP in recent years – exacerbated by the Afghan and Iraq wars and the financial crisis – the ceiling has the potential to provide some real excitement every once in a while.

The Relentless Growth of Debt

Greece, Ireland, Portugal, Spain, Italy, Iceland, the U.S., California . . . the list of governments with debt problems is long and grows longer. The issue has flared up in the last fifteen months and is often in the headlines nowadays.

And yet, the general conditions causing the concern are nothing new. The deficits and debt that worry people today have existed for a good while: similar in kind albeit perhaps

not in degree. This merely shows that in the economic/investment world, what matters most in the short run isn't necessarily what's true but, rather, what's on people's minds.

Serious attention began to be paid to government debt in April 2010, when the Greek crisis burst into the news. Prior to that, no one seemed to worry about the way Greece – like many other countries – increased its budget deficit and national debt each year relative to its GDP. Banks and investors around the world were perfectly willing to extend credit without limitation based on Greece's strong EU-backed credit rating, and without thought as to whether there was any prospect for Greece ever paying down the debt, or even slowing its growth or growing out of it.

If you ask me, one of the most pronounced trends in the global economy over the course of my 42-year career has been the growth in the use of credit. And it's not just governments that have vastly expanded their use of credit over this period.

If I wanted to buy something upon my arrival at college in 1963, I had two choices: I could spend money I had in my pocket, or I could write a check against money I had in the bank. The one thing I couldn't do – now here's a radical concept – is spend money I didn't have. As a result, I had no way to buy things I couldn't afford.

But then, around 1967, Bank of America came out with the first credit card, the BankAmericard, and First National City Bank countered with The Everything Card. (When I was hired into FNCB that year for my first summer job, it was to go door-to-door trying to convince merchants to accept the card. But then volume on the New York Stock Exchange spiked to 25 million shares a day and banks like FNCB couldn't keep up with the related paperwork; thus I was assigned instead to a task force whose job it was to eliminate bottlenecks in the back office. But that's another story.)

Before the BankAmericard and The Everything Card, the only plastic in circulation consisted of T&E (“travel and entertainment”) cards – American Express, Diners Club and Carte Blanche – which generally were limited to people in the upper economic strata and had to be paid off each month. It was only in the last forty years that we've seen the morphing of BankAmericard into Visa and The Everything Card into MasterCard. With them came the ability of consumers to maintain an outstanding balance. Now it was easy for people to buy things they couldn't afford. And so they did.

When I was a boy, as I recall, owing money was considered undesirable and debts were generally expected to be paid off. When people bought homes, they put down 30% and took out thirty-year mortgages to finance the rest. They made level payments that included a substantial principal component that grew over time, eventually extinguished their debt, invited their friends over for mortgage-burning parties, and owned their homes free and clear in time for retirement.

But attitudes toward debt underwent significant change, and in the last forty years we've seen the following:

- Vast expansion of the use of credit cards, the balances on which are never expected to be paid off.
- Innovative mortgages requiring little or no principal amortization; reverse mortgages, where you owe more at the end than the beginning; declining down payment requirements; and eventually the availability of mortgage loans exceeding purchase prices.
- Home equity loans enabling owners to drain off any equity in their homes. Fifty years ago these were called second mortgages, and people who had them were considered by their neighbors to be in financial trouble.
- Growth in corporate debt, and the extension of borrowing power to companies with “speculative” credit ratings.
- The development of the commercial paper market, where companies could access “permanent” capital with maturities measured in days, on the assumption that the paper could always be rolled over.
- Creation of highly levered investment entities.
- Vastly increased steady-state borrowing on the part of nations, whereas, previously, deficit spending had been limited to occasional efforts to fight recession through stimulus.

What's the upshot of all of this? For the last several years, as I've visited with clients around the world, I've described the typical American as follows (exaggerating for effect, of course): He has \$1,000 in the bank, owes \$10,000 on his credit card, makes \$20,000 a year after tax, and spends \$22,000. And what do lenders do about this? They mail him additional credit cards.

Most people laugh – perhaps uncomfortably – when they hear this. But no one says it's inaccurate or benign. The bottom line is that consumer credit has been extended without any thought for how the full balance might ever be paid off. As long as the borrower is able to make monthly payments covering the interest and a tiny bit of principal, the situation is considered acceptable. But that's not my version of fiscal health.

So now let's jump from the top of the above list of developments to the bottom. In much the same way, credit has been available to governments deemed creditworthy without limit and without concern for the fact that:

- Countries were constantly spending more than they were taking in.
- Their deficits were growing non-stop relative to GDP.
- Their national debts likewise were expanding relative to GDP.
- In other words, repayment of principal was absolutely unimaginable.

One of the most striking aspects of debt in the modern era is that little if any attention is paid to repayment of principal. No one pays off their debt. They merely roll it over . . . and add to it. Thus credit ratings are highly deficient (shocker!) in a way that few people talk about. What ratings describe isn't the borrower's ability to repay principal, but its ability to make interest payments and refinance principal. But the assessment of their ability to roll their debt – likewise – isn't based on an ability to repay, but rather to refinance again. So ultimately the security of capital providers stems not from the borrower, but from the continued willingness of other capital providers to roll debts in the future. (It was their occasional refusal in 2007-08 that caused the worst moments of the financial crisis.)

With no one asking how debt could be repaid, nations were allowed for decades to increase their deficits and debt non-stop relative to their GDP. And then, in the first quarter of 2010, the little boy stepped out from the crowd, took note of the emperor's non-existent new clothes, and said "Hey, wait a minute: Greece will never be able to repay even the debt it has, forgetting that it takes on more all the time. Its economy is non-competitive and stagnant, and tax compliance is non-existent. They shouldn't be able to borrow."

That's all it took. Greece was denied further credit. And then people took a look around peripheral Europe and saw more of the same. Today, although the situation is nowhere as dire, they're also looking at the U.S. and some of its states.

It's Not the Ceiling

In June, the debt of the U.S. reached the ceiling, meaning no more could be issued. That's bad news for a country that continuously spends more than it takes in. Thus the deadline imposed by the debt ceiling has brought the issue to the forefront. (If the debt limit was reached in June and we've continued to spend more than our revenues, how have we financed the shortfall? The federal government has borrowed from federal retirement funds; the courts ruled in the past that when we do this, it's not an expansion of our net debt, since America is borrowing "from itself." The well-known deadline of August 2 is the date on which the capacity for borrowing in this way is projected to be exhausted.)

The problem isn't the ceiling, it's our behavior. The debt ceiling merely imposes a discipline that our national leaders should provide but generally haven't. On this note, in his press conference on July 15, when asked about conservatives' insistence on a balanced-budget amendment to the Constitution, President Obama replied, "We don't need a constitutional amendment to do that [balance the budget]; what we need to do is to do our jobs." **But clearly we do need some enforced discipline, because the years in which we haven't run a deficit have been by far the exception of late, not the rule.**

The U.S. has run deficits almost every year since World War II, with prominent surpluses only in 1998-2001.

Go back a few decades, and the characterizations of the two political parties were fairly well established. The Democrats stood for progressive taxation (meaning a higher percentage burden on top earners) and more government spending, especially in aid of those in need. The Republicans were the party of strong defense, small government, fiscal responsibility and balanced budgets.

More recently, neither party has shown resolute fiscal discipline. Both have added unfunded programs. Tax reduction has been discovered as a growth stimulant. The upward march of our deficit and debt has been nearly uninterrupted.

We've seen the enactment of spending programs without providing for increased revenues to pay for them, and cuts in taxes without corresponding reductions in spending. As President Obama put it on July 15:

. . . we cut taxes without paying for them over the last decade; we ended up instituting new programs like a prescription drug program for seniors that was not paid for; we fought two wars, we didn't pay for them; we had a bad recession that required a Recovery Act and stimulus spending and helping states . . .

The blame isn't limited to one party. The increases in deficits and debt took place when both Democrats and Republicans were in power, and while control of government was both divided and in the hands of a single party.

It seems apparent that in recent decades, politics has become more partisan, and solving the nation's problems has taken a back seat to adhering to ideology and getting re-elected. And what gets people elected? Promises of more: more benefits without increased taxation, and more take-home pay without reduced largesse. Only recently have large numbers of politicians begun to face the music, admitting that the government has to either do less or charge people more or both.

Obstacles to a Solution

From my point of view, so much that's illogical is going on regarding these issues that I sometimes find it hard to get my head around the current "debate" (if we can call it that when so few people are conversing). Here's what I think is the logic of the situation (with data from *FactCheck*, July 15):

- Expenditures have risen relative to the economy even as revenues have declined.

Washington's spending has recently been higher as a percentage of the nation's economic output than at any time since World War II. But by the same measure, Washington's revenues are the lowest in more than 60 years.

- The government is spending far more than it brings in. The current deficit is in excess of \$1 trillion, and "the U.S. is borrowing about 36 cents of every dollar spent so far this year. It borrowed 37 cents on the dollar last year, and 40 cents in 2009."

- **There's no way to change these facts in the short run.** In particular:

The largest components of federal spending are Social Security and Medicare programs for the elderly (33.5 percent of total outlays in 2010) and national defense (20.1 percent). Interest payments on federal debt . . . accounted for 5.7 percent of all federal spending.

Thus revenues (which equate to 64% of spending) just slightly more than cover the 59.3% of the budget that went for these inescapable expenditures. What about cutting programs that are unpopular and more discretionary? That wouldn't accomplish much:

Foreign aid . . . amounts to less than 1 percent of the entire budget. . . . All agriculture programs – including farm subsidies – make up just over one-half of 1 percent.

- When deficit spending is unavoidable, we have to borrow.
- Since we're at the current debt ceiling, continuing to borrow requires that the ceiling be raised.
- If the ceiling isn't raised and we can't borrow, we won't be able to make good on all of our obligations. Someone will have to go unpaid: employees, creditors, soldiers, retirees, vendors, etc. I don't think anyone believes we can make good on all of our obligations without borrowing.
- Thus we have to solve this immediate problem. We can enact spending cuts and/or tax increases, but invariably these things will only take effect over the long run. **In the short run we have no choice but to raise the debt ceiling and keep borrowing.**

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- **When the House of Representatives is under the control of one party and the other party is in charge of the Senate and the White House, solving gritty problems requires compromise.**
- A compromise is defined as a solution in which both sides make sacrifices, giving up some of what they want and making concessions to the other side that they find distasteful. On July 14 *The New York Times* cited Sen. Alan Simpson on President Ronald Reagan's pragmatic attitude toward compromise:

He had a rule: If you can agree on 80 percent, take it. He raised taxes 11 times in eight years. He did it to make the country run.

- **But compromise runs directly against ideology and is incompatible with lines drawn in the sand.** Some of today's elected officials have pledged not to permit any increases in taxes. Others have vowed to resist any cuts in entitlement programs such as Social Security and Medicaid. **Some even campaigned on explicit promises not to compromise and not to raise the debt ceiling; for people like these, reaching agreement would be a problem, not a solution.**
- Even among Republicans, it seems that some put the highest priority on balancing the budget while others insist on shrinking the government. This creates a fundamental intra-party conflict, since increasing government revenues represents a way to accomplish the former but is in direct contravention of the latter. (See "Anarchists and Tassel Loafers," *The New York Times*, July 14.)
- There's another important difference of opinion; which is more important, adherence to avowed principles or action to address the short-term problem? Many politicians have made public pronouncements that render the two mutually exclusive.
- **Thus to date enough people have refused to accord first priority to solving the debt problem in the short term that a compromise solution has been rendered unreachable.**

* * *

- The picture is complicated by the fact that any action to reduce the deficit and related borrowing – be it through reduced spending or increased revenues – would have a depressing impact on an economy that is already anemic.
- Thus many people want to maintain or increase spending or cut taxes to stimulate the economy, even though doing so would exacerbate the problems of deficit and debt in the short run.
- There is considerable disagreement over which would be worse for the economy: a \$1 reduction in government spending or a \$1 dollar increase in taxes? Economics is too imprecise to produce a definitive conclusion. And economists have ideologies, too; Republican economists tend to describe revenue increases as more harmful, while Democratic economists are more likely to resist spending cuts.

* * *

- If the debt ceiling isn't raised, as I said, some people will have to go unpaid. Among the candidates are our nation's creditors. Failure to pay creditors is called default.
- Some lawmakers believe that, even if the ceiling isn't raised, we'll manage to pay creditors and avoid default.
- At least until recently, and perhaps still, some of those involved have been unconvinced that failure to act would have grave consequences.

At a closed-door meeting Friday morning [July 15], GOP leaders turned to their most trusted budget expert, Rep. Paul D. Ryan of Wisconsin, to explain to rank-and-file members what many others have come to understand: A fiscal meltdown could occur if Congress fails to raise the debt ceiling. House Speaker John A. Boehner of Ohio underscored the point to dispel the notion that failure to allow more borrowing is an option. "He said if we pass Aug. 2, it would be like 'Star Wars,'" said Rep. Scott DesJarlais, a freshman from Tennessee. "I don't think the people who are railing against raising the debt ceiling fully understand that." (*Los Angeles Times*, July 16)

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- If the U.S. defaults on its debt, our credit rating will likely be cut from triple-A. But there may be people who don't believe this, while others seem unconvinced that it would be a serious development.
- I believe, however, that (a) our rating will be cut if there's a default, (b) this would have serious repercussions for our cost of borrowing, and (c) even if we were able to avoid default and/or downgrade, the feeling that our political leaders had engaged in irresponsible action could reduce lenders' view of our credit and increase our cost of borrowing anyway. **I strongly doubt the dollar can remain the world's reserve currency, of which unlimited amounts are accepted, without unflinching adherence to the associated responsibilities.**
- **Another thing I'm most sure of is that no one knows what the repercussions of default and downgrade would be.** They don't call economics "the dismal science" for nothing. When some people warn of Armageddon, others feel they're exaggerating for effect. There's no way to prove anything on this subject other than by letting it happen.
- Finally, I'm convinced that while it's not certain exactly what will happen if a solution isn't reached, some of the possible results could be very negative.

This situation is incredibly complex and serious. I feel we need a compromise solution, because I'm just not willing to conduct an experiment with consequences that are unforeseeable and could be grave. But the events to date show us that compromise solutions are assured only when there's a broad consensus that an agreement is desirable, and that the consequences of not reaching one are worse than the disadvantages of the compromise. Nothing tells me that such a consensus is prevalent enough to guarantee that the underlying problem of deficit spending will be solved.

The Most Likely Outcome

If you want to get re-elected and suspect that failure to raise the ceiling might hurt your chances – or if you just believe raising the ceiling would be good for the country – you might agree to a compromise in the end. But, given the ideological divide, lawmakers will be more likely to accept a compromise if there's less substance and less teeth in it.

Thus I think a solution will be reached. But given the complexity and difficulty of the issue and the short time remaining before the deadline, it's unlikely to be either detailed or iron-clad. **The most likely outcome here is a short-term, stopgap solution.** It probably won't require the balanced-budget amendment desired by conservatives, the broad spending cuts Republicans want, or the tax increases Democrats insist should be part of any deal . . . some or all of which we clearly need.

In other words, the “solution” is unlikely to represent much fundamental progress; for the most part it’ll just kick the can down the road. It may call for a new commission to study the problem, but:

- the last commission came up with a plan that was hailed by the commission members who were former elected officials, rejected by many of those still in office (who have to face voters), and quickly forgotten, and
- it’s hard to believe that the likelihood of a plan being adopted will be greater without the presence of a deadline for raising the debt ceiling, as opposed to lower.

Progress will be touted, but much of it will be illusory. In that regard, I’m reminded of the recently announced solution in the Minnesota budget stalemate. A good part of the financial shortfall was bridged with an agreement to securitize and sell off payments scheduled to be received in the future as a result of the tobacco settlement. But raising money by selling assets doesn’t permanently fix an excess of expenses over revenues. That’s like selling off manufacturing equipment to save a company that’s operating in the red. (Note that one of the things that keeps government from taking a “businesslike” approach to fiscal issues is the fact that government accounting treats spending on capital assets the same as expenses, and the proceeds from asset sales the same as revenues. No business would join in these mistakes.)

Regardless of the exact methodology, I believe that any “solution” announced this month will (a) fail to make fundamental improvement, and thus in the words of Rahm Emanuel will let the current crisis – with its potential to compel real change – go to waste, (b) delay any real action and (c) fail to reduce the likelihood of recurrence of the debt ceiling problem.

* * *

What we need is this:

- government expenditures that are limited to revenues, with the exception of isolated instances of deficit spending designed to fight recession, where after the deficits are promptly reversed by amassing surpluses, and
- encouragement for economic growth that enables the pie to grow and government to pay for its activities on a current basis.

Anything else would be a short-term palliative . . . or a continued exercise in imprudence. **Spending that grows no faster than GDP should be an imperative. Shrinking government's share of the economy seems highly desirable. National debt that is stable or declining as a percentage of GDP sounds compelling.**

(In addition to balancing the budget and growing the economy, I think we have to accept that the coming decades are likely to see U.S. standards of living decline relative to the rest of the world. Unless our goods offer a better cost/benefit bargain, there's no reason why American workers should continue to enjoy the same lifestyle advantage over workers in other countries. I just don't expect to hear many politicians own up to this reality on the stump.)

To close, I'm going to borrow some quotations and data from Michael Cembalest, Chief Investment Officer of J.P. Morgan Private Bank (*Eye on the Market*, July 18):

The long-term threat:

. . . there are serious questions, most immediately about the sustainability of our commitment to growing entitlement programs . . . the time we have is growing short. (Paul Volcker, *The New York Review of Books*, June 24, 2010)

According to the CBO alternative case (tax cuts do not sunset as planned; AMT keeps getting indexed to inflation; no Medicare cuts take place, etc.), by the year 2024, entitlements plus interest spending will be equal to total government revenue. Just 12 years ago, in 1999, the CBO estimated that this would not happen until 2060. The crossing point has moved in by 36 years.

In 1967, the government estimated that Medicare expenses would grow by 7x by 1990 (unadjusted for inflation); they grew by 61x instead. In addition to the lack of cost controls on entitlements, demographic changes are a problem as well: the ratio of workers to Social Security recipients has declined from 17-to-1 in 1950 to 3-to-1 today.

The short-term threat:

As the largest buyer and holder of U.S. Treasury bonds, we need to seriously assess the risks. We hope that the U.S. government adopts a serious policy to ensure the interests of the investors. (China Cabinet Development Research Center, and the Chinese Foreign Ministry, after the Moody's downgrade watch was announced and S&P reportedly told lawmakers it might downgrade U.S. debt if payments were missed.)

The essential element in any real solution:

The country is so thoroughly given up to the spirit of the party, that not to follow blindfolded the one or the other is an inexpiable offense. Between both, I see the impossibility of pursuing the dictates of my own conscience without sacrificing every prospect, not merely of advancement, but even of retaining that character and reputation that I have enjoyed. Yet my choice is made; I am at least determined to have the approbation of my own reflections. (John Quincy Adams in his diary, on sticking to his principles and supporting the British embargo, knowing that it would harm his home state of Massachusetts and get him thrown out of the Federalist party)

The world has awakened to the undesirability of ever-growing government debt. Repairing the situation will require difficult decisions and great sacrifices, especially on the part of lawmakers required to vote for unpopular solutions. This would be a great time to start taking positive steps.

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