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.

<u>First</u>, 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 <u>and</u> 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 <u>after</u> 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."**

<u>Third</u>, 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.

<u>Fourth</u>, 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.

<u>Fifth</u>, 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.

<u>Sixth</u>, 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.

<u>Seventh</u>, 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.

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