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).

<u>Finding Your Way on an Efficient Highway</u> – 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.

<u>For How Long Will the Fast Lane Go Fast?</u> – 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.)

<u>The Tactics Others Adopt</u> – 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.

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