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.**
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> 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**.
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> 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.
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> 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!**
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> 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.
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> 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.**
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> 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).**
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> 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 <u>increases</u> 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.**
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> Every day, investment managers are required to:
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> - 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.
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> 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.**
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> 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