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.

<u>The Seed</u>

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.**

<u>The L Word Revisited</u>

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.

<u>The Engine of Growth Seizes Up</u>

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