Memo to: Oaktree Clients

From: Howard Marks

Re: The Race Is On

I've written a lot of memos to clients over the last 24 years – well over a hundred. One I'm particularly proud of is *The Race to the Bottom* from February 2007. I think it provided a timely warning about the capital market behavior that ultimately led to the mortgage meltdown of 2007 and the crisis of 2008. I wasn't aware and didn't explicitly predict (in that memo or elsewhere) that the unwise lending practices that were exemplified in sub-prime mortgages would lead to a global financial crisis of multi-generational proportions. However, I did detect carelessness-induced behavior, and I considered it worrisome.

As readers of my memos know, I believe strongly that (a) most of the key phenomena in the investment world are inherently cyclical, (b) these cycles repeat, reflecting consistent patterns of behavior, and (c) the results of that behavior are predictable.

Of all the cycles I write about, I feel the capital market cycle is among the most volatile, prone to some of the greatest extremes. It is also one of the most impactful for investors. **In short, sometimes the credit window is open to anyone in search of capital (meaning dumb deals get done), and sometimes it slams shut (meaning even deserving companies can't raise money).** This memo is about the cycle's first half: the manic swing toward accommodativeness.

An aside: I recently engaged in an exchange with a reader who took issue with my use of the word "cycle." In his view, something is a cycle only if it's so regular that the timing and extent of its ups and downs can be predicted with certainty. The cycles I describe aren't predictable as to timing or extent. However, their fluctuations absolutely can be counted on to recur, and that's what matters to me. I think it's also what Mark Twain had in mind when he said "History doesn't repeat itself, but it does rhyme." The details don't repeat, but the rhyming patterns are extremely reliable.

<u>Competing to Provide Capital</u>

When the economy is doing well and companies' profits are rising, people become increasingly comfortable making loans and investing in equity. As the environment becomes more salutary, lenders and investors enjoy gains. This makes them want to do more; gives them the capital to do it with; and makes them more aggressive. Since this happens to all of them at the same time, the competition to lend and invest becomes increasingly heated.

When investors and lenders want to make investments in greater quantity, I think it's also inescapable that they become willing to accept lower quality. They don't just provide more money on the same old terms; they also become willing – even eager – to do so on weaker terms. **In fact, one way they strive to win the opportunity to put money to work is by doing increasingly dangerous things.**

This behavior was the subject of *The Race to the Bottom*. In it I said to buy a painting in an auction, you have to be willing to pay the highest price. To buy a company, a share of stock or a building – or to make a loan – you also have to pay the highest price. And when the competition is heated, the bidding goes higher. This doesn't always – or exclusively – result in a higher explicit price; for example, bonds rarely come to market at prices above par. Instead, **paying the highest price may take the form of accepting**

a higher valuation parameter (e.g., a higher price/earnings ratio for a stock or a higher multiple of EBITDA for a buyout) **or accepting a lower return** (e.g., a lower yield for a bond or a lower capitalization rate for an office building).

Further, rather than paying more for the asset purchased, **there are other ways for an investor or lender to get less for his money. This can come through tolerating a weaker deal structure or through an increase in risk.** It's primarily these latter elements – rather than securities merely getting pricier – with which this memo is concerned.

History Rhymes

In the pre-crisis years, as described in the 2007 memo, the race to the bottom manifested itself in a number of ways:

- There was **widespread acceptance of financial engineering techniques**, some newly minted, such as derivatives creation, securitization, tranching and selling onward. These innovations resulted in the creation of such things as highly levered mortgage-backed securities, CDOs and CLOs (structured credit instruments offering tiered debt levels of varying riskiness); credit default swaps (enabling investors to place bets regarding the creditworthiness of debtors); and SPACs (Special Purpose Acquisition Companies, or blind-pool acquisition vehicles). Further, the development of derivatives, in particular, vastly increased the ease with which risk could be shouldered (often without a complete understanding) as well as the amount of risk that could be garnered per dollar of capital committed.

- While not a novel development, there was **an enormous upsurge in buyouts**. These included the biggest deals ever; higher enterprise values as a multiple of cash flow; increased leverage ratios; and riskier, more cyclical target companies, such as semiconductor manufacturers.

- There was **widespread structural deterioration**. Examples included covenant-lite loans carrying few or none of the protective terms prudent lenders look for, and PIK-toggle debt on which the obligors could elect to pay interest "in kind" with additional securities rather than cash.

- Finally, there was simply **a willingness to buy riskier securities**. Examples here included large quantities of CCC-rated debt, as well as debt issued to finance dividend payments and stock buybacks. The last two increase a company's leverage without adding any productive assets that can help service the new debt.

Toward the end, my 2007 memo included the following paragraph:

> **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. (emphasis in the original)

Now we're seeing another upswing in risky behavior. It began surprisingly soon after the crisis (see *Warning Flags*, May 2010), spurred on by central bank policies that depressed the return on safe investments. It has gathered steam ever since, but not to anywhere near the same degree as in 2006-07.

- Wall Street has, thus far, been less creative in terms of financial engineering innovations. I can't think of a single new "modern miracle" that's been popularized since the crisis.

- Likewise, derivatives are off the front page and seem to be created at a much slower pace. A full resumption of derivatives creation and other forms of financial innovation appears to be on hold pending clarification of the regulatory uncertainty surrounding acceptable activity for banks.

- Buyout activity seems relatively subdued. In 2006-07, it seemed a buyout in the tens of billions was being announced every week; now they're quite scarce. Many smaller deals are taking place, however, including a large number of "flips" from one buyout fund to another, and leverage ratios have moved back up toward the highs of the last cycle.

- "Cov-lite" and PIK-toggle debt issuance is in full flower, as are triple-Cs, dividend recaps and stock buybacks.

It's highly informative to assess how the other characteristics of 2007 enumerated above compare with conditions today:

- global glut of liquidity – check
- minimal interest in traditional investments – check (relatively little is expected today from Treasurys, high grade bonds or equities, encouraging investors to shift toward alternatives)
- little apparent concern about risk – check
- skimpy prospective returns everywhere – check

Risk tolerance and leverage haven't returned to their pre-crisis highs in quantitative terms, but there's no doubt in my mind that risk bearing is back in vogue.

Examples from the Media

My preparation for writing these memos often includes amassing media citations around a central theme. Here are some from the last few weeks:

- Now, eight years since the PIK-toggle entered the market, companies are again using the esoteric structures, along with a host of riskier borrowing practices associated with the buyout boom that helped inflate the 2006-07 credit bubble. (*Financial Times*, October 22)

- At the same time, more than $200bn of "cov-lite" loans have been sold so far this year, eclipsing the $100bn issued in 2007. That means 56 per cent of new leveraged loans now come with fewer protections for lenders than normal loans. (*Ibid.*)

- Bankers say much of that issuance has been a result of the return of another pre-crisis market vehicle – the collateralised [sic] loan obligation. . . . Like the rest of the leveraged loan market, CLOs have enjoyed buoyant demand. At least $55.41bn of the vehicles have been sold this year – the highest amount since the $88.94bn issued in 2007. (*Ibid.*)

- Bonds rated CCC or lower -- at least eight steps below investment grade -- by S&P have gained 11 percent this year, compared with about a 6 percent gain for all dollar-denominated junk bonds or a loss of more than 1 percent for investment-grade debt, according to Bank of America Merrill Lynch index data. (*Bloomberg*, November 19)

- . . . the amount of indebtedness in leveraged buyout deals is creeping up. The average amount of debt used to finance LBOs has jumped from a low of 3.69 times earnings in 2009 to an average of 5.37 so far this year, according to data from S&P Capital IQ. At the height of the LBO boom, average leverage was 6.05. (*Financial Times*, October 22)

- Subprime loans, given to people with little proven ability to pay, are making a comeback, this time to buy cars. Issuance of bonds linked to loans for the shakiest borrowers hit $17.2 billion this year, more than double the amount sold during the same period in 2010, according to Harris Trifon, a debt analyst at Deutsche Bank AG. (*Bloomberg*, November 19)

- A Goldman Sachs index of [the stocks of] companies with weaker balance sheets has rallied 42 percent this year, almost doubling the gain in a measure of more creditworthy firms. (*Ibid.*)

- Twitter took the first steps in the pricing of its eagerly awaited initial public offering. . . . The social media darling disclosed that it planned to sell 70 million shares at $17 to $20 each. At the midpoint of that range, the offering would raise about $1.3 billion and would value Twitter at about $10 billion, excluding options. . . . Such a valuation would make Twitter more than three times as big as one of the first big Internet giants, AOL . . . (*The New York Times Dealbook*, October 24)

- Twitter is feeling more optimistic about investor appetite for its imminent initial public offering. On Monday morning, the company raised the price range for its I.P.O. to $23 to $25, signaling a bullish outlook ahead of its trading debut this week. The new range increases Twitter's potential market value by several billion dollars. If it prices at the high end, Twitter would be valued at $13.9 billion at the start of its first day of trading. (*Dealbook*, November 4)

- [Twitter] priced its shares at $26 on Wednesday night, giving it a market value of $18.1 billion. On Thursday, Twitter closed at $44.90 a share, 73 percent above its initial public offering price. (*Dealbook*, November 7)

- In a sign of the fervor once again rising around Internet startups, the 23-year-old CEO of [Snapchat] a two-year-old company with no revenue has rejected a $3 billion buyout offer. (*The Wall Street Journal*, November 14)

- Cash is returning to emerging markets, sparking big stock rallies and a surge in fundraising . . . Yield-hungry investors are venturing far into risky territory. Investors snapped up $1.8 billion worth of stock sold by Chinese banks in Hong Kong over the past two weeks, while India's stock market has climbed to record highs. Brazil sold $3.25 billion of debt, its biggest dollar-denominated offering on record, and Pakistan said Monday it plans to sell debt overseas for the first time in six years. (*The Wall Street Journal*, November 7)

- Emerging markets IPOs creep back into London; Emerging market companies are staging a return on the London Stock Exchange after a few quiet years. (*Financial News*, November 5)

Perhaps most tellingly, the November 19 *Bloomberg* story referenced above included the following observation from a strategist whom I'll allow to go nameless: "The analysis at some point shifts from fundamentals to being purely based on the price action of the stock." **When people start to posit that fundamentals don't matter and momentum will carry the day, it's an omen we must heed.**

While the extent is nowhere as dramatic as in 2006-07 – and the psychology behind it isn't close to being as bullish or risk-blind – I certainly sense a significant increase in the acceptance of risk. The bottom line is that when risk aversion declines and the pursuit of return gathers steam, issuers can do things in the capital markets that are impossible in more prudent times.

<u>Why Is Risk Bearing on the Rise, and What Are the Implications?</u>

To set the scene for answering the above questions, I'm going to reiterate and pull together some observations from recent memos.

Psychologically and attitudinally, I don't think the current capital market atmosphere bears much of a resemblance to that of 2006-07. Then I used words like "optimistic," "ebullient" and "risk-oblivious" to describe the players. Returns on risky assets were running high, and a number of factors were cited as having eliminated risk:

- The Fed was considered capable of restoring growth come what may.
- A global "wall of liquidity" was coming toward us, derived from China's and the oil producers' excess reserves; it could be counted on to keep asset prices aloft.
- The Wall Street miracles of securitization, tranching, selling onward and derivatives creation had "sliced and diced" risk so finely – and directed it where it could most readily be borne – that risk really didn't require much thought.

In short, in those days, most people couldn't imagine a way to lose money.

I believe most strongly that the riskiest thing in the investment world is the belief that there's no risk. When that kind of sentiment prevails, investors will engage in otherwise-risky behavior. By doing so, they make the world a risky place. And that's what happened in those pre-crisis years. When *The New York Times* asked a dozen people for articles about the cause of the crisis, I wrote one titled "Too Much Trust; Too Little Worry." Certainly a dearth of fear and a resulting high degree of risk taking accurately characterize the pre-crisis environment. But that was then. It's different today.

Today, unlike 2006-07, uncertainty is everywhere:

- Will the rate of economic growth in the U.S. get back to its prior norm? Will unemployment fall to the old "structural" level?
- Can America's elected officials possibly reach agreement on long-term solutions to the problems of deficits and debt? Or will the national debt expand unchecked?
- Will Europe improve in terms of GDP growth, competitiveness and fiscal governance? Will its leaders be able to reconcile the various nations' opposing priorities?
- Can Abenomics transform Japan's economy from lethargy to dynamism? The policies appear on paper to be the right ones, but will they work?

- Can China transition from a highly stimulated economy based on easy money, an excess of fixed investment and an overactive non-bank financial system, without producing a hard landing that keeps it from reaching its economic goals?
- Can the emerging market economies prosper if demand from China and the developed world expands more slowly than in the past?

Looking at the world more thematically, a lot of questions surround the ability to manage economies and regulate growth:

- Can low interest rates and high levels of money creation return economic growth rates to previous levels? (To date, the evidence is mixed.)
- Can inflation be returned to a salutary level somewhat above that of today? Right now, insufficient inflation is the subject of complaints almost everywhere. Can the desired inflation rate be reinstated without going beyond, to undesirable levels?
- Programs like Quantitative Easing are novel inventions. How much do we know about how to end them, and about what the effects of doing so will be? Will it prove possible to wind down the stimulus – the word du jour is "taper" – without jeopardizing today's unsteady, non-dynamic recoveries? Can the central banks back off from interest rate suppression, bond buying and easy money policies without causing interest rates to rise enough to choke off growth?
- How will governments reconcile the opposing goals of stimulating growth (lower taxes, increased spending) and reining in deficits (increased taxes, less spending)?
- Will prosperous regions (e.g., Germany) continue to be willing to subsidize profligate and poorer ones (e.g., Spain and Portugal)?

As to investments:

- When the Fed stops buying bonds, will interest rates rise a little or a lot? Does that mean bonds are unattractive?
- Are U.S. stocks still attractive after having risen strongly over the last 18 months?
- Ditto for real estate following its post-crash recovery?
- Can private equity funds buy companies at attractive prices in an environment where few owners are motivated to sell?

As I've said before, most people are aware of these uncertainties. Unlike the smugness, complacency and obliviousness of the pre-crisis years, today few people are as confident as they used to be about their ability to predict the future, or as certain that it will be rosy. **Nevertheless, many investors are accepting (or maybe pursuing) increased risk.**

The reason, of course, is that they feel they have to. The actions of the central banks to lower interest rates to stimulate economies have made this a low-return world. This has caused investors to move out on the risk curve in pursuit of the returns they want or need. Investors who used to get 6% from Treasurys have turned to high yield bonds for such a return, and so forth.

Movement up the risk curve brings cash inflows to riskier markets. Those cash inflows increase demand, cause prices to rise, enhance short-term returns, and contribute to the pro-risk behavior described above. **Through this process, the race to the bottom is renewed.**

<u>**In short, it's my belief that when investors take on added risks – whether because of increased optimism or because they're coerced to do so (as now) – they often forget to apply the caution they**</u>

<u>should. That's bad for them. But if we're not cognizant of the implications, it can also be bad for the rest of us</u>.

Where does investment risk come from? Not, in my view, primarily from companies, securities – pieces of paper – or institutions such as exchanges. No, in my view the greatest risk comes from prices that are too high relative to fundamentals. And how do prices get too high? Mainly because the actions of market participants take them there.

Among the many pendulums that swing in the investments world – such as between fear and greed, and between depression and euphoria – one of the most important is the swing between risk aversion and risk tolerance.

Risk aversion is <u>the</u> essential element in sane markets. People are supposed to prefer safety over uncertainty, all other things being equal. When investors are sufficiently risk averse, they'll (a) approach risky investments with caution and skepticism, (b) perform thorough due diligence, incorporating conservative assumptions, and (c) demand healthy incremental return as compensation for accepting incremental risk. This sort of behavior makes the market a relatively safe place.

But when investors drop their risk aversion and become risk-tolerant instead, they turn bold and trusting, fail to do as much due diligence, base their analysis on aggressive assumptions, and forget to demand adequate risk premiums as a reward for bearing increased risk. **The result is a more dangerous world where asset prices are higher, prospective returns are lower, risk is elevated, the quality and safety of new issues deteriorates, and the premium for bearing risk is insufficient.**

It's one of my first principles that we never know where we're going – given the unreliability of macro forecasting – but we ought to know where we are. "Where we are" means what the temperature of the market is: Are investors risk-averse or risk-tolerant? Are they behaving cautiously or aggressively? And thus is the market a safe place or a risky one?

Certainly risk tolerance has been increasing of late; high returns on risky assets have encouraged more of the same; and the markets are becoming more heated. The bottom line varies from sector to sector, but I have no doubt that markets are riskier than at any other time since the depths of the crisis in late 2008 (for credit) or early 2009 (for equities), and they are becoming more so.

<u>Is This a Sell Signal? If Not, Then What?</u>

No, I don't think it's time to bail out of the markets. Prices and valuation parameters are higher than they were a few years ago, and riskier behavior is observed. But what matters is the degree, and I don't think it has reached the danger zone yet.

First, as mentioned above, the absolute quantum of risk doesn't seem as high as in 2006-07. The modern miracles of finance aren't seen as often (or touted as highly), and the use of leverage isn't as high.

Second, prices and valuations aren't highly extended (the p/e ratio on the S&P 500 is around 16, the post-war average, while in 2000 it was in the low 30s: now that's extended).

A rise in risk tolerance is something that should get your attention and focus your concentration. But for it to be highly worrisome, it has to be accompanied by extended valuations. I don't think we're there yet. **I think most asset classes are priced fully – in many cases on the high side of fair – but not at bubble-type highs.** Of course the exception is bonds in general, which the central banks are supporting at yields near all-time lows, meaning prices near all-time highs. But I don't find them scary (unless their duration is long), since – if the issuers prove to be money-good – they'll eventually pay off at par, erasing the interim mark-downs that will come when interest rates rise.

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In the 1950s, when I was a kid, I watched old movies on TV when I got home from school. One from the 1940s was called *It Happened Tomorrow*. In it, a struggling young journalist made a deal with the devil to be given a peek at the next day's news. His scoops brought him huge success, and everything ran smoothly until he received a newspaper headlined "Reporter Shot Dead at Racetrack." He tried all he could to avoid it, but as a result of some very clever plot devices, he of course ended up at the track (where he learned that the headline had resulted from a case of mistaken identity).

I go through all of the above to explain that – try as I might to avoid it – my memos on excessive risk bearing and what to do about it invariably end up back at the same place: my favorite Buffettism:

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

I repeat Warren's injunction for the simple reason that you just can't put it any better. When others are acting imprudently, making the world a riskier place, our caution level should rise in response. (It's equally true that when others become overly cautious and run from risk, assets get so cheap that we should turn aggressive.)

Over the last 2-3 years, my motto for Oaktree has been consistent: "move forward, but with caution." I feel the outlook is not so bad, and asset prices are not so high, that it's time to apply maximum caution (or, as they said in *The Godfather*, "go to the mattresses"). But by the same token, the outlook is not so good, and asset prices are not so low, that we should be aggressive. That's the reason for my middling stance.

Having said that, however, there's no doubt in my mind that the trend is in the direction of increased risk, and I see no reason to think that trend will be arrested anytime soon. Risk is likely to reach extreme levels someday – it always does, eventually – and great caution will be called for. Just not yet.

Here's my conclusion from *The Race to the Bottom*. I'll let it stand – another case of "ditto."

> . . . 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.

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