Memo to: Oaktree Clients

From: Howard Marks

Re: Everyone Knows

> **par·a·dox** *n* **1** a seemingly absurd or self-contradictory statement that is or may be true . . . **4** an opinion that conflicts with common belief. (Collins English Dictionary)

I'm sometimes asked to speak about investing with the choice of topic wide open. I like to begin by saying the thing I find most interesting about investing is how paradoxical it is: how often the things that seem most obvious – on which everyone agrees – turn out not to be true.

I'm not saying accepted investment wisdom is sometimes valid and sometimes not. The reality is simpler and much more systematic: **What's clear to the broad consensus of investors is almost always wrong.**

First, most people don't understand the process through which something comes to have outstanding moneymaking potential. And second, the very coalescing of popular opinion behind an investment tends to eliminate its profit potential.

I've been saving up ideas for a memo about how often the investing herd is wrong and accepted wisdom should be bet against. Then along came the March 1 issue of Mark Faber's "Gloom, Boom and Doom Report" and its lead quotation from William Stanley Jevons (1835-1882). Another chance for someone else to help me say it better, this time from 100-plus years ago:

> As a general rule, it is foolish to do just what other people are doing, because there are almost sure to be too many people doing the same thing.

<u>"Common Sense" and Other Oxymorons</u>

Take, for example, the investment that "everyone" believes to be a great idea. In my view by definition it simply cannot be so.

- If everyone likes it, it's probably because it has been doing well. Most people seem to think outstanding performance to date presages outstanding future performance. Actually, it's more likely that outstanding performance to date has borrowed from the future and thus presages sub-par performance from here on out.
- If everyone likes it, it's likely the price has risen to reflect a level of adulation from which relatively little further appreciation is likely. (Sure it's possible for something to move from "overvalued" to "more overvalued," but I wouldn't want to count on it happening.)
- If everyone likes it, it's likely the area has been mined too thoroughly – and has seen too much capital flow in – for many bargains to remain.

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- If everyone likes it, there's significant risk that prices will fall if the crowd changes its collective mind and moves for the exit.

Superior investors know – and buy – when the price of something is lower than it should be. And the price of an investment can be lower than it should be only when most people don't see its merit. Yogi Berra is famous for having said, "Nobody goes to that restaurant anymore; it's too crowded." It's just as nonsensical to say, "Everyone realizes that investment's a bargain." If everyone realizes it, they'll have bought, in which case the price will no longer be low.

<u>The Anatomy of a Bargain</u>

"Is it a good idea?" That's what everyone wants to know. And from time to time, popular opinion unites behind an investment, anointing it as a good idea – the next solution – the low-risk sure thing – the "silver bullet." Often this crowd mentality creates a self-fulfilling prophecy . . . for a while.

I've seen it many times in my 39 years in this business: "it's a good idea to invest in the stocks of high-growth companies" (or energy stocks, small companies, disc drive companies, emerging markets, venture capital funds, technology stocks, hedge funds, real estate, China and India, or private equity). But just as often, I've stated my view: **There's no such thing as a good idea. Only a good idea at a price.** Something can be a very good idea at one price and a very bad idea at another.

Invariably when I hear the media and the herd describe something as a good buy, it's without regard for price. They never say, "Internet stocks are a good buy at p/e ratios up to 50." Or "class-A office buildings are a good buy as long as the cap rate exceeds 7%." Or "private equity's a good idea at purchase prices below seven times EBITDA." Just "it's a good buy."

My response is simple: **There is no investment idea so good that it can't be ruined by a too-high entry price. And there are few things that can't be attractive investments if bought at a low-enough price.** When investors forget these simple truths, they tend to get into trouble.

<u>How Money Is Made</u>

The fact is, there is no dependable sign pointing to the next big moneymaker: a good idea at a too-low price. Most people simply don't know how to find it. If someone really knew, why would he share his knowledge? And when the investing herd or some media commentator expresses an opinion, they're invariably pointing in the wrong direction.

Large amounts of money (and by that I mean unusual returns, or unusual risk-adjusted returns) aren't made by buying what everybody likes. They're made by buying what everybody underestimates.

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In short, there are two primary elements in superior investing:

- seeing some quality that others don't see or appreciate (and that isn't reflected in the price), and
- having it turn out to be true (or at least accepted by the market).

It should be clear from the first element that the process has to begin with investors who are unusually perceptive, unconventional, iconoclastic or early. That's why successful investors are said to spend a lot of their time being lonely. As I wrote in "Dare to Be Great," non-conformists don't get to enjoy the warmth that comes with being at the center of the herd. But it should be clear that when you're one of many buying something, it's unlikely to be a special opportunity. It's only when few others will buy that you can get a bargain.

That's the thinking behind a brilliant observation that I heard in the 1970s, describing the three stages of a bull market:

- the first, when a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone believes things will get better forever.

The loners who buy from a crowd of dispirited sellers can get a good deal – and high returns – because they're few in number and early. But when every Tom, Dick and Harriet joins the herd, after the merits of the situation have become obvious to all, they can't expect a bargain; the merits must be reflected fully – or to excess – in the price. In fact, each of those latecomers bears the risk of being the last to jump on the bandwagon . . . just before it goes off the cliff.

<u>The Best Companies in America</u>

As readers of these memos know, I first worked in the Investment Research Department of First National City Bank (now Citibank) in 1968. Whereas common stocks traditionally were bought on the basis of their issuers' current book value and earnings, "growth investing" recently had come into fashion. Under this new approach, buyers paid higher-than-usual valuation multiples for the stocks of "growth companies" in recognition of the above-average rates at which their earnings were projected to increase in the future.

Growth investing reached its zenith in the pursuit of the "Nifty Fifty," and that's the style the bank pursued to the virtual exclusion of all others. It consisted of buying the stocks of the best, fastest-growing companies in America, companies like IBM, Xerox, Polaroid, Kodak, Hewlett Packard, Texas Instruments, Perkin Elmer, Merck, Lilly and Avon. Each one was a corporate icon, or what I call a "head nodder" – one person says "Xerox" and everyone else nods and says "great company." **Head nodders are like silver bullets: always the subject of broad, unquestioning adoration, and thus invariably overpriced.**

The trap, of course, is that when everyone agrees something's a great company, it invariably comes at a great-company price. Some will turn out to actually be great companies, but the

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buyers of their stocks have already paid in full for greatness. Others will disappoint, and the stock of a disappointing company that's been bought at a great-company price can be a disaster.

By 1970, the scene had been set for just such a development by the Nifty Fifty investors' attitude toward valuation: "**These companies are so good, and growing so fast, that there's no such thing as a price that's too high**. If the price seems excessive given this year's earnings, just wait; the earnings will grow enough to justify the price." Those who participated can say they cared about price, but I never heard of anyone refusing to hold those stocks just because they were priced too high. Such discipline is rarely seen during investment manias.

The rest, as they say, is history. In the early and mid-70s, the wheels fell off. Common stock investing, which had become extremely popular, fell out of favor. Business Week ran its famous cover story, "The Death of Equities." The economy became mired in stagflation. Great companies' earnings failed to grow and sometimes contracted. Nifty Fifty stocks that had traded at p/e ratios of 80 and 90 fell to p/e ratios of 8 and 9 (really). And The Wall Street Journal eventually ran its customary listing of stocks that had lost 90% – a possible buy signal that depressed investors routinely ignore.

So we had a quick lesson in the folly of buying on supposed merit alone, without regard to price. But the lesson continued. Here in 2007, only a few of those "Best Companies in America" are still thought of as such. In fact, IBM, Xerox, Kodak and Polaroid all became distressed in the interim and required turnarounds. Warren Buffett made a related observation in this year's Berkshire Hathaway Annual Report: "Of the ten non-oil companies having the largest market capitalization in 1965 – titans such as General Motors, Sears, DuPont and Eastman Kodak – only one made the 2006 list."

The lesson is simple: beware sweeping statements, accepted wisdom and eternal verities, and look for pearls others haven't recognized.

<u>The Worst Companies in America</u>

I know I tend to repeat myself in these memos – my wife Nancy never fails to remind me – but I don't think I've ever told the whole story of my entry into the world of high yield bonds.

In 1978, shortly after having organized and begun to manage Citibank's convertibles securities fund, I got a call from the boss: "There's some guy named Milken or something who works for a small brokerage firm in California. He deals in 'high yield bonds,' and a client wants us to manage a portfolio for them; can you find out what they are?" Obviously, that brief conversation changed my life.

Everyone associates Michael Milken with high yield bonds (no one says "junk" anymore), but few people know exactly why or how. Mike was neither the inventor (first to create) nor the discoverer (first to find) of bonds rated below investment grade. He's just the person who did the most with them. Here are the facts:

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- For as long as bonds have been rated, there've been low-rated bonds. But prior to the late 1970s, non-investment grade bonds couldn't be issued as such. Rather, they were "fallen angels": bonds issued with investment-grade ratings that were subsequently downgraded due to deterioration on the part of their issuers.

- At Wharton, Mike read a 1958 study by W. Braddock Hickman which showed that over the period 1900 to 1949, lower-rated bonds had produced higher realized returns on average than higher-rated bonds. Sure some low-rated bonds defaulted, but higher yields and lower purchase prices on the many that didn't default more than made up for the ones that did.

- Mike concluded that low-rated bonds were an overlooked asset class; even for a weak credit, there had to be some yield that would compensate for the credit risk; thus it should be possible to issue bonds with speculative ratings; and he could make it happen.

- Thus Mike's contribution consisted of raising the profile of the asset class and proselytizing for it, making a market in high yield bonds and underwriting new issues. He wasn't the only one, just the most prominent figure by far. And the expansion of the universe of new issue high yield bonds from $2 billion to $200 billion that Mike presided over between 1978 and 1990 provided early impetus for the growth of buyout investing into the major activity it is today.

By the time I got the call described above, Mike had joined Drexel Burnham Lambert, started the high yield bond department, moved it to California and begun to underwrite new issue high yield bonds for corporate borrowers. He visited me at the bank in the fall of 1978, and it was even more of a learning experience than the one I got from the Nifty Fifty. Mike's logic was the direct opposite, and to me much more appealing. Here's what he told me:

- If you buy triple-A or double-A bonds, there's only one way for them to go: down. The surprises are invariably negative, and the record shows that few top-rated bonds remain so for very long.
- On the other hand, if you buy B-rated bonds and they survive, all the surprises will be on the upside.
- Because the investment process is prejudiced against high yield bonds, they offer yields that more than compensate for the risk.
- Thus you'll earn a superior yield for having accepted the incremental credit risk, and favorable developments can lead to capital gains as well.
- Your main goal should be to weed out bonds that may default.
- But diversification is essential, too, because some of the bonds you hold will default anyway, and your positions in them mustn't be large enough to jeopardize the overall return.

What an object lesson! What an epiphany! Buy the stocks of the best companies in America at prices that assume nothing can go wrong? Or buy the bonds of unloved companies at prices that overstate the risk of default, and from which the surprises are likely to be on the upside? Having seen fortunes lost investing in the best, it seemed much smarter to buy the worst at too-low prices.

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"If we avoid the losers, the winners will take care of themselves." Sound familiar? The motto we chose for Oaktree was inspired by a lot of people and events, but the morning I spent with Mike Milken in 1978 was the biggest single source of inspiration.

<u>The Perversity of Risk</u>

"I wouldn't buy that at any price – everyone knows it's too risky." That's something I've heard a lot in my life, and it has given rise to the best investment opportunities I've participated in. In fact, to an extent, it has provided the foundation for my career. In the 1970s and 1980s, insistence on avoiding non-investment grade bonds kept them out of most institutional portfolios and therefore cheap. Ditto for the debt of bankrupt companies: what could be riskier?

The truth is, the herd is wrong about risk at least as often as it is about return. A broad consensus that something's too hot to handle is almost always wrong. Usually it's the opposite that's true.

I'm firmly convinced that investment risk resides most where it is least perceived, and vice versa:

- When everyone believes something is risky, their unwillingness to buy usually reduces its price to the point where it's not risky at all. Broadly negative opinion can make it the least risky thing, since all optimism has been driven out of its price.

- And, of course, as demonstrated by the experience of Nifty Fifty investors, when everyone believes something embodies no risk, they usually bid it up to the point where it's enormously risky. No risk is feared, and thus no reward for risk bearing – no "risk premium" – is demanded or provided. That can make the thing that's most esteemed the riskiest.

This paradox exists because most investors think quality, as opposed to price, is the determinant of whether something's risky. But high quality assets can be risky, and low quality assets can be safe. It's just a matter of the price paid for them.

The foregoing must be what Lord Keynes had in mind when he coined one of my favorite phrases: ". . . a speculator is one who runs risks of which he is aware and an investor is one who runs risks of which he is unaware." In 1978, triple-A bonds were considered respectable investments, while buying B-rated bonds was viewed as irresponsible speculation. Yet the latter have vastly outperformed the former, few of which remain triple-A today.

Elevated popular opinion, then, isn't just the source of low return potential, but also of high risk. Broad distrust, disregard and dismissal, on the other hand, can set the stage for high returns earned with low risk. This observation captures the essence of contrarianism.

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The Unhelpful Consensus

The bottom line is that what "everyone knows" isn't at all helpful in investing. What everyone knows is bound to already be reflected in the price, meaning a buyer is paying for whatever it is that everyone thinks they know. Thus, if the consensus view is right, it's likely to produce an average return. And if the consensus turns out to be too rosy, everyone's likely to suffer together. That's why I remind people that merely being right doesn't lead to superior investment results. If you're right and the consensus is right, your return won't be anything to write home about. **To be superior, you have to be more right than the average investor.**

Let me give you an outstanding example of a dangerous consensus. Historic data, buttressed by two decades of good returns, produced near unanimity in the late 1990s regarding future equity returns. Ask 100 institutional investors and consultants in 1999, and virtually 100 would say "about 11%." There was little serious dissent. As a result, equity allocations were ratcheted up. Those who'd fallen behind because they were underweighted in equities earlier in the decade capitulated and bought more.

Where did the support for that 11% number come from? It's simple: recent results. Earlier work at the University of Chicago had put the average annual return on stocks closer to 9% into the 1960s, but a couple of decades of much higher returns pushed the cumulative experience – and thus the expectation – toward 11%. Shouldn't there have been support apart from experience? Was there an underlying economic process that would make stocks worth 11% more each year? Couldn't the last fifteen years, averaging well above 11%, have borrowed from the future by pushing up p/e ratios? Few people inquired. "You can't fight the tape," they said in essence. Who was willing to take the risk associated with a below-average weighting?

Well, the elevated prices produced by that unanimously positive expectation, a reversal of the optimism it embodied, and the fact that those above-trend results had in fact borrowed heavily from the future all led eventually to the first three-year decline in equities since 1930. And, not surprisingly, to a new consensus. Now everyone says "about 7%." But is today's consensus any more likely to be right? Or does it just reflect more of that oxymoronic quality, common sense?

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Asset Class Returns

Further on the topic of consensus expectations, let me visit the question of whether asset classes even "have" expected returns. I learned from managing fixed income portfolios that bonds come closest to having a dependable return. Over its life, a bond that's bought at a 10% yield to maturity and doesn't default will return 10%, won't it? An obvious truth? No, actually something of a misstatement.

The majority of the lifetime return on a long-term bond comes not from the promised interest payments and redemption at maturity, but from the interest earned on interest payments after they're received. The yield to maturity at which a bond is bought expresses the overall return that will be earned if interest rates don't change – that is, if interest payments are reinvested at the rates prevailing at the time of purchase. But because interest rates are highly variable, so is the "interest on interest" component. Few non-bond people realize how un-fixed even fixed income investing is, and how substantial is the "reinvestment risk." And beyond bonds, it's even more up for grabs.

What rate of return is implicit in equity investing? Certainly we should look to more than just returns over the last ten or twenty years for the answer. The rate of growth in corporate profits provides a clue, but in the short run, changes in p/e ratios tend to swamp changes in profits.

In 1999, investors asked, "What's been the return on common stocks?" and were seduced by the 11% answer propounded by authorities like Prof. Jeremy Siegel in his book, "Stocks for the Long Run." What they should have asked, however, is, **"What's been the return on common stocks bought when the Standard & Poor's 500 was priced at 29 times earnings?"** (which it was at the time). In other words, people made the mistake of believing that common stocks have a single rate of return you can depend on, regardless of entry point. **They forgot the great extent to which the return on an asset is dependent on the price you pay for it.**

In the March/April 1997 issue of the Financial Analysts Journal, Peter Bernstein set forth a helpful way to consider returns from equities – one I'd thought about but had never seen in use. He calculated returns on the S&P 500 for periods spanning widely separated dates between which the p/e ratio didn't change. He called the result "valuation-adjusted long-run equity returns." In December 2006, he published some interesting results. With the S&P 500 trading at 17.2 times earnings, he looked at four periods which had begun with the p/e at the same 17.2 and found that the returns over those periods had ranged from 10.4% to 11.1%.

In other words, over periods when multiples were unchanged, the S&P 500 did deliver roughly 11%. And in the very long run, over the course of which the impact of p/e fluctuations is watered down, stocks also have returned 11%. Thus it seemed reasonable for buyers of stocks in 1999 to expect returns of 11% per year. But they failed to think about what might happen if p/e ratios fell in the short run.

It shouldn't take a Ph.D. (or even an MBA) to know that if you buy the S&P in 1999 at a p/e ratio of 29, one of the highest multiples ever seen, the p/e ratio could decline and the resulting return could be below 11% – well below 11% if it happened quickly. In 1999, investors derived excessive comfort from an optimistic consensus that was based on long-run data. But in 2002, they were licking wounds inflicted in the short run. It's worth noting that for the seven years that ended March 31, 2007, the annualized return on the S&P 500 was 0.9%. **So much for the crowd's certainty regarding 11%.**

And what about the return on private equity? Before saying what it'll be, investors should think about where returns come from. Some markets derive their returns from an underlying process. As far as I'm concerned, owning interests in money-making companies and income-producing real estate has such an underlying basis for returns, whereas owning gold and art does not.

Companies produce profits, and thus buying interests in them represents buying into a stream of returns. When a private equity fund buys a company today at nine times EBITDA (which, let's say, equates to eleven times cash flow after capital expenditure needs), that implies a 9% free-cash-flow return on invested capital – and maybe 5% after fees and expenses. The rest of the return that's hoped for must come from doing other things: leveraging up the equity at a cost

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below 9%, making the company more productive, or selling it at an increased valuation. But the ability to do these things is either highly dependent on market conditions (leveraging cheap or selling dear) or skill-based. The wide disparity among private equity results for any given period of time shows how much they are a function of the skill of the general partners, and thus that most of the return on private equity is far from intrinsic to the asset class.

<u>Everyone Knows</u>

Two years ago, the herd knew residential real estate was a can't-miss way to build wealth. "You can live in it," "it's a hedge against inflation," and "they're not making any more land" were oft-recited mantras . . . just as they had been in the mid-1980s (See "There They Go Again," April 2005). After ten years of rapid appreciation, owners of condos felt they had it made, and non-owners felt they were on the outside looking in. People lined up to put down deposits on condos that hadn't been built yet, and many assembled portfolios that way.

No one talks that way anymore. The air came out of the condo balloon fast once prices stopped going up, putting the virtuous circle into a stall. The cheap financing that appeared to provide a ticket to financial security is now seen to have lured many buyers into water over their heads. **"It can only go up" and "if it stops working, I'll get out" – two phrases that are heard in the course of virtually every financial mania – proved once again to be highly flawed.**

To avoid the trap in residential real estate, one needed a memory of events that occurred more than ten years earlier, the ability to understand their implications, and the discipline to resist joining the herd. Many failed the test and succumbed to yet another investment craze.

Just think about the many things everyone agreed on in the last decade, and how overdone these fads turned out to be – or may turn out to be in the future.

- "Everyone" loved emerging markets in the mid-90s, with their concept of per capita consumption catch-up . . . until the Russian debt debacle and the collapse of Long-Term Capital Management busted that bubble for a while.
- A fellow member of a non-profit investment committee insisted in 1999 that we had to invest the endowment in a hi-tech fund . . . just before its portfolio lost more than 90%.
- Hedge funds were widely touted as the surefire solution to the weakness that stocks demonstrated in 2000-02, in time to see the average return recede to unexciting single digits.

Great recent performance and a failure to detect risky patterns have cost investors money on several recent occasions . . . and always will. Now silver bullets ranging from private equity to art are being touted as ways to make big money without risk . . . ignoring the unlikely nature of that proposition, as usual. There's plenty of evidence of the popularity of these ideas. Maybe they'll work forever. Maybe these trees will grow to the sky. But if they do, they'll be the first.

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Finally, it's important to remember that investment trends regularly go to great extremes, meaning "overpriced" and "overdone" are far from synonymous with "going down tomorrow." As Lord Keynes said, "The market can remain irrational longer than you can remain solvent." Thus, whatever it is the herd is favoring, a manager might either (a) hold a little to ensure that it doesn't continue doing well without him on board, making constituents question his judgment, or (b) avoid holding any, but he should be prepared to look wrong for a while. Anyone who's tempted to blow the whistle on a market trend just because it has gone too far or is priced too high must bear in mind one of the greatest adages of all: **"Being too far ahead of your time is indistinguishable from being wrong."**

There's always a period – sometimes a long one – when those who follow the crowd look smart and the abstainers look dumb. But the roles are inevitably reversed in the long run. **Insisting on buying value and controlling risk can seem awfully dowdy at times, but for us, there is no other way.**

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