

Memo To: Clients

From: Howard S. Marks, TCW

Re: Risk in Today's Markets

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The ability of the stock market to react so harshly on February 4 to a small, Fed-mandated rise in interest rates, pushing the Dow down 96 points, suggests a lack of preparedness for negative developments. This prompts me to write to you about certain risks I feel may be present in the markets today.

There are plenty of bullish arguments to be made about the prospects for the economy and corporate profits, and pundits to make them. While I will not devote space or time to them, I don't pretend they are nonexistent. And I won't deny the possibility that as an inherently cautious investor, I sometimes tend to overstate the negatives. What I want to do, however, is point out the degree to which I feel investors are behaving in a risk-tolerant manner today, and the implications for all of us.

Two very powerful trends are at work, and have been for the last few years. The first is the decline in interest rates, which has carried rates to the lowest levels of the last thirty years and brought on great dissatisfaction with the returns available from low-risk fixed income investments. The second is the fabulous performance which was produced by virtually all investments in securities from 1991 to 1993. This was a period in which risk-taking was rewarded, and almost without exception very high returns went to those who took great risk.

Put these two phenomena together and what do you have? I think the answer is an environment in which risk-taking is greatly encouraged.

It is often said that the market runs on fear and greed, but I believe it usually runs on fear or greed; that is, at most points in time, one or the other predominates. Right now, because of the two trends cited above, greed is greatly elevated and, perhaps more importantly, fear is in short supply. Thus,

- the money market investor, not content to earn 3% per year, (a negative return after taxes and inflation), turns to notes and bonds,
- the bond investor, unhappy with returns at the shorter (read "low-risk") end of the curve, extends maturities,
- the high grade bond investor drops down in quality,
- the fixed income investor turns to equities,
- the equity investor joins a hedge fund,

- the domestic investor looks overseas,
- the international investor emphasizes emerging markets, and
- the traditional bond-and-stock investor searches for "alternative investments" likely to repeat the success of the LBO and bankruptcy funds.

And why shouldn't they? The "stick" is the low prospective return offered in each investor's traditional bailiwick, and the "carrot" is the high returns earned recently in the riskier sectors. In brief, "why should I settle for 3% in T-bills when I can get double-digit returns in stocks?"

There are numerous signs of infatuation with -- or non-questioning acceptance of -- the pursuit of high returns. The torrential inflow of dollars to mutual funds is one; I recently attended a conference at which a fund group representative said they were taking in \$100 million a day, 90% of it for foreign funds. The rising level of margin debt is another. Books on investing are reaching the best-sellers list. The names of hedge fund managers are almost household words.

And that brings me, for purposes of illustration, to the subject of hedge funds. When I first got to know the money management community twenty years ago, only a handful of managers were good enough to command a share of the profits as compensation. Today, according to a recent article in Forbes, there are 800 hedge funds, and some people think being accepted by one of the big names is the chance of a lifetime.

I think it's important to remember, though, the symmetrical nature of most investments: almost every sword is two-edged, and he who lives by a risky strategy may die by it. Investments which will make you a great deal of money when things go well but not lose you a lot when things go poorly are very rare, and their existence must presuppose extremely inefficient markets. With the average stock or bond returning 10-15% last year, how did some hedge funds make 70% or more? It was through bold and heavily-leveraged plays on macro-developments such as currency movements. What would have happened if the managers' calculations had proved wrong? The hedge fund manager I know with the best performance last year, up more than 100%, is said twice in his life to have lost 30% in one day! Do the hedge fund aficionados know how much risk they are taking? For how long are they tying up their money? How much do they know about the strategies being employed? As the Forbes article pointed out, the sum of the "information" most hedge fund investors receive is a quarterly paragraph reporting the rate of return.

I am not complaining about the fact that there are hedge funds, or about their popularity. My point is simply that the level of risk borne by investors is being systematically raised, often unknowingly and at a time when many valuations are quite high.

Comparison against low interest rates makes low earnings yields and dividend yields seem tolerable. Likewise, low rates increase the discounted present value of companies' future earnings as calculated by valuation models. For these reasons and others, many valuation indicators are at levels today which have proved dangerous and unsustainable in the past. Just as today's low interest rates are pushing investors toward riskier securities all along the "food chain" described above, however, this sword can also cut the other way.

Warren Buffet said, in one of my favorite adages, "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." Another adage I'm fond of is, "What the wise man does in the beginning, the fool does in the end." No course of investment action is either wise or foolish in and of itself. It all depends on the point in time at which it is undertaken, the price that is paid, and how others are conducting themselves at that moment.

When everyone shrinks from a security because it's "too risky," the few who will buy it can do so with confidence, secure in the knowledge that the price has not been bid up, and in the likelihood that others will eventually outgrow their fear and jump on the bandwagon. Today, many prices have been bid up, and the bandwagon is already crowded with wild-eyed investors.

It is my view that, first, few of the trends being pursued are at their beginnings; money has been flowing to today's popular sectors for at least a year or two. Second, while some may argue that prices are not forbiddingly high, it's almost impossible to argue that they're very low (or that the easy money hasn't already been made). Third, it seems to me that investors are accepting higher levels of risk throughout the system.

Here's one illustration: Our cautious high yield investing saved clients a lot of money and heartache in 1989 and 1990. Because we apply in-depth, downside-conscious credit analysis to the high yield segment of the bond market, and define it narrowly, investors who were chastened by the last decline and don't want to bear the full brunt of the next one have hired us repeatedly in the years since. Now, however, we detect increased interest in more "eclectic" managers who will buy cash-paying or non-cash-paying bonds, going concerns or bankruptcies, convertible or straight bonds, and U.S. or foreign debt. This is just one example, near to us, of the new acceptability of risk -- at what just might be the wrong time.

Too-low interest rates and too-high prices may prove at some point to have set the stage for a correction. If so, many of the riskier tactics to which recent trends are pushing investors will increase the extent to which that correction is felt. What course of action, then, would we argue for?

**We do not preach risk-avoidance.** In fact, the knowing acceptance of risk for profit is at the core of much of what we do, and we feel there is an important role today for investing which is creative and adaptable. But we would take this opportunity to exhort you to review most critically the risk associated with your current and contemplated

investments, and not to be among those who uncritically joined the trend toward risk. Whatever investment opportunities you decide on, we would encourage you to stress thorough appraisal of the risks entailed and cautious implementation.

**What is it that distinguishes the investment opportunities we'd suggest you pursue today? Not just the offer of high returns, but of returns which are more than proportionate to the risk entailed.** The reason we champion inefficient markets (such as the high yield bonds, convertibles and distressed debt we're involved with) is that there exists by definition the potential, if exploited correctly, for an uncommonly favorable ratio of return to risk.

**Exploitation of opportunities in inefficient markets; insistence on preserving capital; refusal to pursue maximum return at the cost of maximum risk; specialization rather than dabbling; heavy emphasis on careful analysis; use of less-risky senior securities -- these themes have been the cornerstones of our approach over the years. They remain highly relevant and should continue to be pursued by all of us, especially at this point in the cycle.**

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