

Memo to: Oaktree Clients

From: Howard Marks

Re: Tell Me I'm Wrong

My readers treat me well. They indulge my penchant for dissecting the past, and they send kind messages of encouragement. To repay their generosity, I'm going to venture into something I usually avoid: the future of the U.S. economy.

This memo won't be about the future in general, just the elements I find worrisome. As I see it, every investor is either predominantly a worrier or predominantly a dreamer. I've come clean many times: I'm a worrier. By saying that, I absolve myself of having to describe the whole future. I'm going to cover the negatives, starting with the immediate and ending with the systemic (some of the latter repeats themes from "What Worries Me," August 28, 2008). For the other side of the story, I'd suggest you consult the optimists who seem to be in charge of the markets these days.

The Near Term

One thing is indisputable: the rally in financial markets worldwide has outpaced the fundamentals. At the beginning of 2009, most onlookers expected a generally weak economy and were concerned that the behavior of consumers and banks would remain conservative. They were 100% right, and fundamentals are still tenuous. And yet, the rally has exceeded all expectations of which I'm aware.

Market participants have grasped at slender "green shoots": things that are declining but at a slower rate, or that have stopped getting worse, or that have begun to improve, albeit anemically (e.g., "At some of the nation's largest lenders, the number of consumer loans that are going bad is starting to level off." *The New York Times*, January 21). Most of the good news falls into those categories; little or nothing has blown anyone's socks off. We haven't seen much economic news that's overwhelmingly positive, despite the fact that (a) today's comparisons are against very weak periods a year ago, (b) our exports have been made cheaper by a dollar that's 10-20% lower, and (c) there's been an enormous amount of government stimulus. The gains being reported are often in tenths of a percent, and the other day my drive-time radio commentator said, "Hirings are almost equal to firings." That doesn't tell me we're in the midst of a strong recovery, or on track for one.

In particular, most companies' sales remain quite weak. The economy is generating very little growth at the so-called "top line" on which Gross Domestic Product is based. Rather, the profit gains being reported have been aided in large part by cost cutting. But "cost cutting" and "productivity gains" are nice-sounding ways of saying companies are getting by with less labor. Thus the employer's productivity gain can be the employee's job loss. It doesn't bode well for

the general welfare, consumer spending or GDP growth if the level of business activity, as seen in revenues, isn't rising; GDP doesn't benefit from profit margin expansion.

Reliance on Government Stimulus

A year or so ago, the government came to the rescue of the economy with massive stimulus. With the Great Depression as a reference point, Bernanke et al. were determined to limit the contraction in liquidity, support financial institutions and encourage economic activity. Some say too much has been spent, the resulting deficits are worrisome, and the program's a flop, since the economy's still languishing and unemployment remains high.

But the fact that growth is sluggish doesn't mean the stimulus has failed. The relevant question isn't how the economy is doing, but how growth compares against what it would have been without the stimulus. "What if" questions like that are largely unanswerable, but I'm sure we're much better off than we would have been without the government's help.

Home sales are weak, but what would they be if the federal government wasn't directly or indirectly backing 80-85% of all new mortgages and providing \$8,000 tax credits to first-time home buyers? What would 2009 auto sales have been without the "cash for clunkers" program? GDP growth is insubstantial, but what would it be if government spending hadn't risen by double digits?

Although not all the money has been well spent – "a blunt and messy solution" according to William Dudley, president of the New York Federal Reserve (*The New York Times*, January 21) – it seems clear the stimulus program has prevented a much more dire outcome. Regardless, the economy's response is tepid, and I wonder whether the slow growth reflects negative underlying secular trends. This makes me tend toward an expectation that the recovery will be lackluster, and that it will take years before we get back to anything approaching the vibrancy of the period preceding the crisis.

I fall back on the analogy of a stalled car (the economy) being pulled by a tow truck (government stimulus). The tow truck will want to let the car down one of these days and go on its way. Will the car be able to move on its own? We can only wait and see. I think it's more likely to sputter along than it is to move forward energetically. But at least we don't have to worry any longer about the analogy of fifteen months ago: an airplane whose engine has flamed out. A powerless plane in mid-flight presents a far more troubling image than a stalled car.

The Role of Interest Rates

Interest rate reduction has played an extremely important part in the government's efforts to end the crisis and bring the economy back to life.

- By reducing short-term interest rates (in this case to near-zero), the government makes it more attractive to spend and invest, stimulating the economy. This is the most direct effect.

- Lower rates also provide a direct subsidy to financial institutions, which can borrow cheaply and lend at higher rates. (If a bank can borrow \$100 from the government at 1% and lend it out at 6%, it's as if the government wrote the bank a check for \$5 – but more subtle and perhaps less vexing to Main Street, and with potentially positive multiplier effects.) Given the state of financial institutions in 2008, it's clear this element was essential.
- There's a third, less direct effect. Rock-bottom rates on Treasuries push people to chase high returns by undertaking riskier investments. A year ago, the pensioner living on interest opened his year-end mutual fund statement and saw that the return on his T-bill or money market fund was close to zero. He grabbed the phone and called the company to say, "Get me out of that fund and into the one that's paying 15%" . . . and so became a high yield bond investor.

It's clear from the behavior of the markets that something has been goosing investment performance, since the best gains have been seen in the fundamentally riskiest assets. Part of it is general easing of the excessive risk aversion and fear of a year ago, and part is a justified rebound from too-low prices. But certainly near-zero interest rates have played a major part.

As with most remedies – economic and otherwise – ultra-low interest rates raise questions:

- Will economic recovery continue if rates go to market levels?
- Will financial institutions remain viable without the subsidy of low rates?
- Can the residential real estate market recover without support from cheap mortgages?

But what if rates remain low?

- Will foreigners continue to lend the U.S. the money it needs to cover its deficits?
- Can the dollar hold its value against other currencies if international demand weakens for dollars with which to invest in the low-yielding U.S.?
- Most market participants tend to extrapolate currency movements (rather than project their reversal). So if low rates cause the dollar to weaken, will non-U.S. investors shy further from our currency to avoid continued weakness, exacerbating these issues?

Global considerations call for higher rates, but fighting domestic economic weakness relies on low rates. Resolving this dilemma won't be easy . . . or painless.

The Importance of Consumer Spending

At two-thirds of GDP, consumer spending was the linchpin of U.S. economic growth in the decade-plus leading up to the credit crisis. And the foundation for the rapid growth in that spending was the availability of consumer credit and the willingness to use it.

The innovation and explosion of consumer credit, which I view as having begun in the 1970s, enabled Americans to spend money they didn't have to buy things they couldn't afford. This was compounded in the current decade by vastly lowered credit standards for first mortgages and by radical expansion of what used to be called second mortgages but were re-labeled "home

equity loans.” The final element in the equation was the decline in the savings rate to roughly zero in the last decade. Thus consumers spent all they made and, in many cases, more.

These trends enabled growth in spending to exceed the growth in incomes, adding substantially to the growth in GDP. Few people seemed to understand that increases in home prices weren't inexorable, or that there was anything wrong with incurring debts without a foreseeable way to repay them. Shopping became a national pursuit, and fads like “investment dressing” and “investing in collectibles” made reckless spending seem rational.

This all fell apart when the uptrend in home prices collapsed and consumer credit and home loans became unavailable. Fear suddenly replaced limitless optimism among consumers, shopping became dispensable, and the savings rate rebounded to around 5% – meaning spending suddenly grew slower than incomes (which themselves were contracting). The trend in consumer spending, which had buoyed the economy, now led its decline. Further, businesses saw no reason to expand inventories or factory capacity, transferring the slowdown to the manufacturing sector.

What will happen in the future? Will spending rebound? Or will the swing toward frugality and savings be permanent? I recently read an article which dismissed the latter possibility, saying, “People still want a better life.” **I don't doubt that, but what if that “better life” comes to be defined as having more savings and less debt, rather than a new car or another handbag?**

According to *The Wall Street Journal* of December 17:

. . . businesses ranging from shoemakers to financial services to luxury hotels don't expect American consumers to return to their spendthrift ways anytime soon. They see consumers emerging from the punishing downturn with a new mindset: careful, practical, more socially conscious and embarrassed by flashy shows of wealth.

Prudence dictates that people should have savings. But I hasten to point out that “should” isn't the same as “will.” There's a maxim that “No one ever went broke underestimating the intelligence of the American consumer.” I'd prefer to see consumers save rather than return to over-spending – it's healthier for families and for the economy in the long run, providing reserves in case of emergency and capital for investment. But I won't be shocked if they don't.

The Outlook for Real Estate

Just as happened in homes, commercial real estate saw an explosion of excesses in the years leading up to the crisis. Investors and funds – perhaps pursuing the myth that real estate is a good inflation hedge regardless of the price paid – were aggressive buyers.

Capitalization rates or “cap rates” (the demanded ratio of net operating income to price) fell to 4% and sometimes less, implying price/earnings ratios of 25 or more. Property buyers applied those ratios to peak operating income and financed their purchases with copious amounts of debt.

Right now, most borrowers are avoiding default, sometimes abetted by lenders practicing “pretend and extend.” What they’re pretending is that commercial real estate loans will be repayable upon maturity.

It seems inescapable that over the next few years:

- higher vacancy rates and lower rents will keep net operating income from returning to the peak levels of the last cycle,
- property buyers won’t go back to finding sufficient risk compensation in pre-crisis cap rates, and
- financial institutions aren’t going to lend the same high percentage of property purchase prices as they did 3-4 years ago.

Any one of these factors would make it hard for commercial real estate to again command its pre-crisis prices, or for it to be financeable or refinanceable at those levels. Together, the three elements mean many properties are “upside-down” today. That is, their market value is less than the debt against them.

Will a \$100 million loan secured by an \$80 million building be repaid or refinanced? Unlikely. And since that description covers a great deal of commercial real estate today, many real estate loans will go unpaid at maturity. That implies widespread losses for investors and write-downs for lenders.

Many small and medium-sized banks have too much local real estate and construction loans in their portfolios. They fell for the myth of safety in real estate and forgot about the need for geographic diversification. Thus, in addition to real estate bankruptcies, the next few years may see numerous small bank failures.

State and Local Governments

I’m surprised how little we read today about municipal finances. In addition to regularly spending more than they took in (thanks to the miracle of borrowing), many state and local governments got into the habit of ratcheting up budgets in good times, establishing or expanding irreversible spending programs. Thus, today’s substantial declines in sales, income and property tax revenues can’t be met with corresponding cuts in spending.

So now we have massive deficits in places like New York and California – the result of strong spending at a time of soft income. The situation in the latter, my home state, is further complicated by (a) the ability of voters to enact new spending programs through referendums without having to worry about where the money will come from, (b) the fact that the most famous referendum of them all – Proposition 13 – essentially prevents homes from being reassessed to reflect appreciation and (c) the requirement that the annual budget be approved by two-thirds of the legislators in each house, virtually ruling out any unpleasant medicine. It’s for that reason that California resorted to paying its bills in scrip (a practice since discontinued) and furloughing state employees.

Will states and cities go bankrupt in coming years? What will be the effect on their bondholders, and on the municipal bond market as a whole? How will bankruptcy be reconciled with municipal bond issuers' promises to dedicate their full faith and credit to paying interest and principal (and thus, implicitly, to raise taxes without limitation)? How will the federal government respond? If it opens its coffers to bail out profligate states, what will that say to states that were prudent enough to stay out of trouble? No answers here, but lots of trouble in sight.

Our Dance with China

Here are the facts:

- China has vast resources, human and otherwise.
- It produces goods cheaper than the developed countries.
- China's likely undervalued currency aids its competitiveness as an exporter.
- The U.S. buys more from China than it sells to China.
- That means dollars keep piling up in China.
- The U.S. has to borrow back those dollars to fund its fiscal and trade deficits.
- We'd prefer low interest rates in order to minimize our interest payments, and a weak dollar so we can repay our debts (as if!) in devalued currency.
- China, with its reserves growing, has to invest large amounts of dollars.
- China wants high rates and a strong dollar in order to maximize the value of our future payments to them.
- China would probably like to diversify the investment of its reserves away from the dollar, but (a) it's hard to figure out where to better invest them and (b) doing so would further weaken the dollar, of which China already owns so many.

The great thing about not being an economist is that I don't have a view on how all of this will play out. But I'm sure it implies considerable uncertainty.

Wherefore Jobs?

I wonder what will occupy the millions of Americans dependent until now on "physical" jobs. In the late nineteenth century, agriculture became mechanized and many people left the South to find manufacturing jobs in the Midwest. Then manufacturing was automated over time, and the economy went global, reducing the need for American factory workers. Today, relatively little manufacturing takes place in the high-cost U.S. Increasing percentages of our jobs are now in services, government, healthcare, retailing, intellectual property and information.

In "What Worries Me," I expressed concern about an American economy that manufactures less and less, as well as puzzlement regarding the consequences. Where will jobs come from as the population grows and manufacturing continues to shrink?

In addition to replacing 7.2 million lost jobs [since the recession began in December 2007], the economy needs an additional 100,000 a month to keep up with population growth. If the job market returns to the rapid pace of the 1990s – adding 1.25 million private-sector jobs a year, double the 2001-2007 pace – the U.S. wouldn't get back to a 5% unemployment rate until late 2017, Rutgers University economist Joseph Seneca estimated. (*The Wall Street Journal*, October 5, 2009)

“We'll give each person a diploma and a laptop” seems to resonate from the last presidential campaign, but I don't see that as much of an answer to the problem since (a) not every strong back can be redirected to a desk job, especially given that our system of public education is in crisis, and (b) one of the advantages of an information economy is supposed to be that it needs fewer workers to get business done.

In short, I worry that the growth in jobs in the recovery will be slow, and that unemployment and underemployment will remain stubbornly at higher levels than in the past. That doesn't bode well for either the short-term cyclical recovery or the long-term outlook.

Global Competitiveness

Now that the world is one big market and consumers have their choice of goods from anywhere in it, success in producing and selling is largely a function of cost competitiveness. For years, things like the superiority of American products blunted foreign competition. One of the results was that the American worker enjoyed the highest wages and standard of living in the world. But now China, Korea and other nations have eclipsed much of our manufacturing advantage, allowing them to produce goods that are not just cheaper but at times better.

It stands to reason that today, goods produced with high-priced inputs will not compete successfully. In order for U.S. goods to be competitive, our costs will have to come down, and with them our relative standard of living. Why should any country's workers be able to command a higher standard of living if the goods they produce aren't demonstrably superior?

These trends have already taken effect in “legacy industries” like airlines and autos. For example, one of the main goals of the auto bankruptcies was to limit retirees' lifetime benefits. I think we'll continue to see declining relative costs in the U.S., to the betterment of our competitiveness but the detriment of our workers.

Inflation, Exchange Rates and Interest Rates

The macro question I get most often concerns the outlook for inflation. And as someone who lived through stagflation in the 1970s and paid interest at 22-¾%, I think it's very much worth considering.

The hyperinflation of the '70s was sparked by the Oil Embargo of 1973. Labor contracts and benefit plans containing cost-of-living adjustments built on that to create a cost-plus cycle in

which inflation lifted wages, contributing further to inflation, and so forth. Rising prices frightened people into demand-pull inflation by convincing them to stock up on goods to avoid higher prices later. And people borrowed to invest in assets like land out of a belief that no matter what interest rate they paid to finance their purchase, the asset's price would increase at a faster rate (the epitome of inflationary thinking).

No one knew how to solve the problem. I used to go to hear “Dr. Gloom” and “Dr. Doom” (economists Al Wojnilower of First Boston and Henry Kaufman of Salomon Brothers) compete to be more depressing. They talked about how hard it would be to get inflation down to “an acceptable level.” One day, I heard someone ask for the definition of “an acceptable level.” He was told “one-third less than whatever it is at the time.”

Finally, however, in the early 1980s Paul Volcker and the Fed implemented the painful solution of significantly higher interest rates, inflation subsided, and the stock market took off. Over the next 25 years, rising inflation and interest rates were forgotten as possible sources of risk.

Today, labor in the U.S. lacks the power to demand strong wage increases or COLAs. Further, the sluggish macro picture argues against demand-pull. Strong inflation is usually associated with higher levels of prosperity and stronger demand for goods than I foresee. Finally, inflation often presupposes pricing power on the part of manufacturers, which I also don't see.

Those are the factors that argue against an increase in inflation. However, because of other forces – primarily financial and international – it could take increasing numbers of dollars to buy a given quantity of the imported goods on which we've become so dependent (a.k.a. inflation).

- As I mentioned earlier, debtors want there to be inflation so they can repay their debts with currency that's worth less. To accomplish this, debtor nations have the ability to debase their currencies by printing more of it. For the clearest example, see “The Limits to Negativism” (October 15, 2008) on the subject of the Weimar Republic. Post-World War I Germany was assessed war reparations it couldn't afford, so it simply over-stamped its 1,000 mark notes “1 million marks.” All of a sudden it had created enough marks to pay its debt to the world . . . and destroyed the purchasing power of its currency.
- A dollar weakened by reduced demand for it (e.g., as a vehicle for the investment of China's reserves) would, likewise, equate to more dollars per item bought from abroad.
- Finally, “stores of value” like gold hold value only because people agree they will. The same goes for currencies. Profligate spending, runaway deficits and declining world position could reduce the role of the dollar as a reserve currency, again cutting into its purchasing power.

I'm certainly in no position to predict a decline in the purchasing power of the dollar (that is, a bout of strong inflation). However, I do think it's very much worth worrying about.

When Paul Volcker left the Fed in 1987, he was asked at his first public appearance, “Will interest rates go up or down?” He answered presciently: “Yes.” Of course, his answer is still the right one. **But from today's levels, I think rates are more likely to go up than down (there's so little room for the latter).**

Reduced faith in the dollar means it would take higher interest rates to attract non-U.S. buyers to dollar investments. And, even domestically, (a) one of these days the government will stop holding rates down and (b) higher inflation would require rates to rise to compensate for the fact that the dollars with which debts are repaid will buy less. For all these reasons, I think investors must consider the prospect of higher inflation, dollar weakness and higher interest rates.

What to do about them? The list of possibilities is long:

- Buy TIPS.
- Buy floating rate debt.
- Buy gold (but only at the “right” price, and what’s that?)
- Buy real assets, such as commodities, oil and real estate (ditto).
- Buy foreign currencies.
- Make investments denominated in foreign currencies.
- Buy the securities of companies that will be able to pass on increased costs.
- Buy the securities of companies that own commodities, or that own assets denominated in foreign currencies.
- Buy the securities of companies that earn their profits outside the U.S.
- Hold cash (to invest once interest rates have risen).
- Sell long-term bonds (and possibly go short).

These are the actions that can profit from – or that provide the flexibility to adjust to – increased inflation, a decline in the dollar and increased interest rates, all of which are interconnected. The most important one is the last one: long-term bonds could suffer worst in an inflationary, higher-rate environment, especially given today’s low starting yields.

One final point: When I provide this answer to the frequent question about inflation, I ask people whether they agree. Usually they do. Then I ask how much of their portfolio they’re willing to devote to protecting against these macro forces. If their answer is 5%, 10% or 15%, I point out that that’s pretty close to doing nothing. The question is whether you’re willing to devote at least 30-40%. Few people are.

But that’s the thing: It’s easy to say, “I’m worried about inflation.” It’s something very different to say, “I’m worried enough about inflation to do something meaningful about it.” Let me know when you decide how much you’re willing to devote.

The Environment for Business

Moving all the way out on the timescale, I’d like to say a few words about some of my biggest-picture concerns.

I worry about long-term problems that are being left untreated, such as our massive deficits and our under-funded Social Security, Medicare and education systems.

I worry about the long-term impact of government involvement in business decisions: telling companies what they should pay top employees and setting minimums for the percentage of premium revenue that a health insurer should pay out in benefits, for example. The Obama administration has the smallest percentage of Cabinet secretaries with backgrounds in the private sector of any president since Teddy Roosevelt, according to the November 24 issue of *Forbes*. People in the executive and legislative branches with no experience in business are telling business how to operate.

Lastly, I worry about the rising tide of populism and anti-business sentiment. I've never seen negative attitudes like those toward financial institutions today. Administration members with Wall Street backgrounds are regarded with suspicion; high incomes are considered wrongful; and banks and investment banks are seen as victimizing America, not rendering it prosperous. Schadenfreude is in the ascendancy, with people wishing ill for successful bankers. Politicians pander by throwing gasoline on the fire. With an election coming up, I expect candidates to compete to see who can be tougher on Wall Street.

I mentioned in "What Worries Me" that decades ago, when a socialist-leaning labor movement was ascendant in the U.K., I came across a good explanation for the success of U.S. business:

When the worker in England sees the boss drive out of the factory in his Rolls Royce, he says, "I'd like to put a bomb under that car." When the American worker sees the boss drive out in his Cadillac, he says "I'd like to own a car like that someday."

More recently, in 2005, Thomas Friedman compared old and new economies as follows:

French voters are trying to preserve a 35-hour work week in a world where Indian engineers are ready to work a 35-hour day. Good luck. . . .

Voters in "old Europe" – France, Germany, the Netherlands and Italy – seem to be saying to their leaders: stop the world, we want to get off; while voters in India have been telling their leaders: stop the world and build us a stepstool, we want to get on. . . .

A few weeks ago Franz Müntefering, [then] chairman of Germany's Social Democratic Party, compared private equity firms – which buy up failing businesses, downsize them and then sell them – to a "swarm of locusts."

The fact that a top German politician has resorted to attacking capitalism to win votes tells you just how explosive the next decade in Western Europe could be, as some of these aging, inflexible economies – which have grown used to six-week vacations and unemployment insurance that is almost as good as having a job – become more intimately integrated with Eastern Europe, India and China in a flattening world. ("A Race to the Top," *The New York Times*, June 3, 2005 – emphasis added)

Capitalism, free enterprise, pro-business policies, adaptability, work ethic and profit – these are the concepts that have generated most of the material progress in this world.

They were behind much of America's relative gains in the twentieth century, just as they now hold great promise for China, India and Brazil. Compare the growth records and prospects of countries that exhibit them against countries that don't. **Which kind of country will the U.S. of the future be?**

Today people seem to think of companies like Goldman Sachs and JPMorgan Chase as enemies, not friends – companies to be rooted against, not for (and there are non-financial examples as well). I'd like those people to tell me what engine of progress will propel America ahead in the twenty-first century. It's not going to be the barbershops and fast-food outlets. It has to be big, world-leading businesses, working on behalf of their investor-owners.

We're a big country, and we'd better pull for big business – not against it. We'd better remember that "what's good for business is good for America." If we don't, and if big business isn't allowed to thrive, wondering about the shape of the coming recovery or the outlook for security prices in 2010 will amount to nothing more than "rearranging the deck chairs on the Titanic."

Investment performance in a single year should matter principally to people who're going to liquidate their portfolios at the end of that year. Most of us expect our holding periods to go on well beyond 2010. So we'd better hope for a salutary long-term environment in which to hold.

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I'm not writing to be negative or to depress readers. And as I said earlier, I don't claim to be presenting the whole picture. Nevertheless, I hope I'm providing a service.

The question isn't whether there'll be a recovery, but what type. In fact, a recovery is doubtless underway as I write. But for the reasons enumerated above, I think it'll turn out to be anemic and possibly marked by fits and starts, not a powerful "V."

- The recovery will face headwinds in the form of declining manufacturing and weak job creation.
- Slow job growth, sluggish incomes, spending that grows slower than incomes, and scarcer consumer credit likely will combine to limit the consumer's ability to energize the economy.
- Removing the props of elevated government spending, debt guarantees and artificially low interest rates will limit its vibrancy.
- We'll continue to face challenges in terms of real estate losses, bank write-downs and fiscal and trade deficits.

On the other hand, near-term economic statistics will benefit from the following:

- easy comparisons against depressed prior levels,
- the rebuilding of inventories and refilling of pipelines to meet recovering demand, and

- big companies' large cash holdings, delevered balance sheets and eagerness to respond to increased orders.

When people ask me when we'll get back to normal, I ask what they mean by normal. If they mean an environment like 1992-2007, I tell them those were unusually good times, not what the "normal" of the future is going to look like.

The fifteen (or 25) years just prior to the credit crisis were marked by strong, consumer-led growth; rapidly increasing use of credit; American leadership in media, software, technology and financial products; and powerful bullishness and expansiveness. I doubt the years just ahead will be equally positive.

My goal in this memo isn't to express a forecast. I know no forecast – and certainly not mine – is likely to be correct. What I do want to do is caution that the considerable risks I see may be less than fully appreciated by those setting asset prices today. The greatest market risks lie in failure of the macro economy to live up to the expectations embodied in today's prices. **Please tell me if you think I'm wrong in letting the factors described above push me toward caution. In fact, I'd love it if you told me my worries are unfounded, and that our economic and business future will see a complete return to good times.**

Most people view the future as likely to repeat past patterns, which it may or may not do. They tend to think of the future in terms of a single scenario, whereas it really consists of a wide range of possibilities. (Remember Elroy Dimson's trenchant observation that "risk means more things can happen than will happen.") And to the extent they do consider a variety of possibilities, few people include ones that haven't been part of recent experience.

The uncertainties discussed above tell me today's distribution of possibilities has a substantial left-hand (i.e., negative) tail, probably greater than at most times in the past. The proper response should be to discount asset prices, allowing a substantial margin for error. Forecasts should be conservative, yield spreads should incorporate ample risk premiums, valuation parameters should be below the long-term norms, and investor behavior should be prudent.

And yet, the powerful rally of 2009 has more than offset the decline of 2008 in many asset classes. To the extent that the resultant valuations incorporate optimism, I would argue for caution today. A lot of "easy money" was made last year; in retrospect, all you had to do was have access to capital and the guts required to invest it at the absurd low prices of late 2008/early 2009 and hold on during the wild recovery. **Of course, those things were far from easy at the time.**

The profits ahead won't be easy money. They'll require careful selection, appropriately high risk consciousness, insistence on margin for error, and cooperation from the forces that determine outcomes (such as luck). With most assets valued about fairly today, caution, discernment and discipline – not much needed in 2009 – have replaced guts as the essential elements in profitable investing.

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