Memo To: Clients

From: Howard S. Marks, TCW

Re: "Risk in Today's Markets" Revisited

Seven weeks ago, we put out a memorandum entitled "Risk in Today's Markets." Its essence was that the excellent returns earned in risky strategies through 1993 had eroded the fear factor in many markets and, coupled with the low yields available on conservative fixed income investments, had caused many investors to take "one giant step forward" on the risk curve. It also pointed out that just as declining rates had acted to raise prices and generate good returns, rate movements could cut the other way too. Lastly, it cautioned that when others are acting imprudently, driven by greed and without much fear, it is important that we raise <u>our</u> level of prudence.

Unfortunately, the events of the intervening seven weeks have shown these observations to be in order. It is the purpose of this follow-up memo to review the developments of the intervening time period, attempting to make sense out of what has happened and searching for lessons that can be drawn. It's about understanding basics of investing which don't come and go.

The current "correction" dates from February 4, when the Federal Reserve Bank raised short term interest rates a small amount in order to choke off inflationary thought and action. The air quickly came out of the bond markets, and the decline has been swift and deep. Although there were good days for a while as well as bad, the bond market never did recover its equilibrium once the rate rise had begun. The yield on the 30-year Treasury bond rose from 6.21% on January 28 to 7.40% on April 4, with its price falling 14%, from 100.41 to 86.22. The decline spread quickly to other asset classes, and many investors in riskier strategies suffered harsh consequences.

Some observers protest that economic and industry fundamentals continue to be favorable. But those positive developments had come to be valued too highly, and the resulting correction of valuations has been painful. <u>It's important to note the first lesson, then: successful investing has at least as much to do with what you pay for an asset as it does with what that asset's fundamentals are</u>.

But why did the Fed's half-point bump up in short rates cause such devastation? First, of course, even a small step in terms of policy-related tightening implies there may be much more to come. More importantly though, the move suddenly took a big bite out of investors' optimism and reawakened their fear. Through January, investors acted as if nothing could go wrong. That first rate rise served to remind them that something could go wrong -- and had. Thus there has been a swing back from a euphoric extreme.

After the Fed's raising of rates opened their eyes to the negatives, investors also took notice of the tensions with Korea, Japan and China, the strength of the yen, and uncertainty over Whitewater. At the same time, Mexico's stock market had its own correction, in reaction to the assassination of the leading presidential candidate. The important lesson to be learned here is that whenever market participants act as if nothing can go wrong (or right), that represents an extreme swing of psychology -- of the pendulum we wrote about in April 1991 -- that must be recognized for what it is and acted on. As Roseanne Rozanadana used to say on Saturday Night Live, "it's always something." <u>Investment actions predicated on everything continuing to go well are bound to fail</u>.

If the spark that set off the decline in bond prices was the rate increase, why did the slump spread to so many other markets, including equities, foreign bonds, and commodities? Where were the benefits of strategic diversification? I would respond citing the following factors:

- First, interest rates affect the value of everything. Investing consists of putting out money today in order to get more back at a later date. The "discounted present value" of the projected future proceeds varies inversely with the current level of interest rates. Simply put, when rates rise, the present value of a future dollar declines.

- Another reason the impact of rates is broad stems from the fact that, as I was once told by sid Cottle (of Graham, Dodd and Cottle fame), "Investing is the discipline of relative selection." That is, the attractiveness of x is in part a function of the price of y. If bonds cheapen and thus come to promise higher prospective returns, stocks (or any other asset) will appear relatively less attractive at their old prices and thus must cheapen as well in order for their prospective returns to regain competitiveness versus those of bonds.

- Further, it used to be, for example, that Americans determined the prices of U.S. stocks based on U.S. economic developments and Europeans determined the prices of European stocks based on European developments. These were local markets then, and they behaved differently. Today, investing is more globalized, and the prices of assets in different countries are determined by many of the same people, who may respond in common to fundamentals and psychology.

- The last reason many assets have moved together is that in this particular episode, many hedge funds managers (who, as we will discuss later, appear to have had a disproportionate impact on recent events) were forced by their increased capital to invest aggressively in macro-trends spanning national borders. This small group of hyper-active investors may have hooked markets up to an unusual degree.

For these reasons and others, asset prices may prove more highly interconnected than one had expected.

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The most noteworthy feature of the recent correction may be the role of some prominent hedge fund managers. It was reported on February 25 that George Soros's Quantum Fund had lost $600 million on its yen position in one day. On April 1, we read that Michael Steinhardt had lost $1 billion of his $5 billion under management, due largely to the drop in bond prices, and that in the last two months, investors in Askin Capital Management's Granite Funds may have lost 100% of their $600 million capital in mortgage backed securities.

Hedge funds occupied a meaningful part of our February 17 memo because they were felt to exemplify (to a power of ten) the risk-tolerant behavior of investors in general. Thus their subsequent experience can offer us some valuable and highly magnified insights. The important observations, applicable to all investment behavior, are as follows:

- **Words alone mean very little**. Just as "portfolio insurance" turned out in the 1987 Crash not to insure much, today's startling losses indicate that many "hedge funds" don't really hedge enough to make a difference, and that the Granite Fund, which described itself as "market neutral," was anything but.

- Following from the above, we are reinforced in the belief that some investors don't know what their managers are doing, or how much risk they're taking. As one "fund of funds" which had invested in the Granite Fund told the Wall Street Journal, "It's unbelievable. This was touted as a low-risk, low-volatility, market-neutral investment. We were clearly misled." **Only by really knowing what a manager does can you be sure he is right for you**, but this often comes down to whether the manager truly understands his market, describes it accurately and does what he says he will -- things that can't be assessed from a marketing brochure.

- **Investment strategy really is a two-edged sword**, and he who lives by an aggressive strategy usually can die by it. It proved possible for investors to become too comfortable with volatility -- when it was on the upside and called "profit." Volatility is a lot less enjoyable when it turns to the downside, but it's the flip side of the same coin.

- The outcome can actually be worse than symmetrical when incentive fees are involved, as Jan Greer of William Simon & Sons points out. That's because while hedge fund managers took 20% of last year's big profits, they won't replace a like percentage of subsequent losses. Usually, due to the peculiarities of the math, if a portfolio is up 50% one year and down 33% the next, it's back to where it started. But if the manager takes a fifth of the 50% gain in year 1, a 33% decline in year 2 will leave it 7% under water.

- As an experienced corporate director told Forbes a few years ago, "I no longer expect people to do what I tell them to do; I've learned they only do what I pay them to do." But while a hedge fund manager may have his reputation and some capital at stake, as to fees he is in a heads-we-win-tails-you-lose position. For a manager who is paid a percentage of the profits on a one-year-at-a-time basis, a single year of investing aggressively enough at the right time can make him rich for life. Thus **managers should be entrusted with incentive fee arrangements only if they can truly be counted on to add significant value which is <u>not</u> accompanied by proportionate risk**.

- **Volatility + leverage = dynamite**. Only now do we see articles pointing out (after the fact) that if a hedge fund borrows short to buy long Treasury bonds with 6% "down," a 1% rise in the bonds' yield will wipe out 100% of the equity in the position.

- **When volatile securities have been bought on margin, sale may be forced if the investor can't come up with more capital during a decline**. This is a big part of what put the Granite Fund under. If you own securities without borrowing, you may experience a price drop -- which will hopefully prove temporary -- but you can't be put out of the game.

- One characteristic of many inefficient markets is some measure of illiquidity. Thus when sales are forced in a chaotic market -- whether by margin calls, client withdrawals or cold feet -- they can have the effect of contributing to or exacerbating the decline. Often in this environment, the manager's choices for liquidation will be limited to his highest quality and most marketable holdings. In this way, **forced sales can easily contribute to a deterioration of portfolio quality**. When the Granite Fund received margin calls, its manager could only get reasonable bids for securities which perform well when rates rise. Selling them cost the fund its hedge.

The prominent hedge funds that attracted the recent attention -- favorable in 1993 and less so this year -- are multi-billion-dollar entities which, because of their size, often invest not in the undervalued micro-situations on which their early records were built, but in macro-phenomena all around the world. Thus they provide an important object lesson to which we want to point.

These funds are run by managers who pursue aggressive returns through the use of highly leveraged and thus volatile positions in large markets, some of which, such as Treasury bonds, are relatively efficient. **In this sense, they represent the opposite of what we espouse**.

Our approach emphasizes the low-risk exploitation of inefficient markets, as opposed to aggressive investment in efficient ones. We restrict ourselves to markets where it is possible to know more than other investors. We put avoiding losses ahead of the pursuit of profits. And we do not seek to employ leverage.

Inefficient markets must by definition entail illiquidity and occasional volatility, but we feel unleveraged and expert investment in them offers investors with staying power the best route to high returns without commensurately high risk.

And we also feel investors who are capable of observing clinically can learn some valuable lessons from the current episode. We look forward to learning along with you.

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