To: Clients

From: Howard Marks

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Subject: "How Does an Inefficient Market Get That Way?"

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**In an efficient market**, the actions of intelligent, informed, diligent and objective investors cause assets to be priced fairly based on the available information such that their prospective returns are in proportion to their risk. No bargains are available, and the only way to increase expected return is to take on more risk.

But **in an inefficient market**, this process breaks down. The prerequisites for efficiency are not fully satisfied, and thus prices are able to diverge from what they "should" be. Some assets become overpriced and others underpriced. Profits can be earned by applying skill, not just for bearing risk. It becomes possible to consistently achieve superior risk-adjusted returns.

But how does a market get that way? There are many possible reasons. Maybe most investors ignore the market niche because it is little known. Perhaps information is skimpy or unevenly disseminated. Market infrastructure may be under-developed, so trading difficulties scare investors away. Maybe there's no trade reporting, so Seller A doesn't know what B got just a few minutes earlier and settles for less. The list of possible reasons goes on and on, but we have our own favorite: **Investors fail to act objectively and dispassionately**.

An efficient market must be unbiased. That is, the participants must be motivated just by economics and willing to either buy or sell depending on price. If every owner wants to (or must) sell a given good and won't become a buyer no matter how low the price goes, the price of that good can fall below the "fair" level and it will become possible to find bargains. Conversely, prices can go too high when everyone wants to own something . . . whether it's tulip bulbs, South Sea pearls or nifty-fifty stocks.

And that brings us to the high yield bond market which remains, in our opinion, decidedly inefficient. High yield bonds continue to offer 350-400 basis points more yield than "riskless" Treasury bonds to compensate for the risk of losing 50-150 basis points per year to credit problems. And high yield bonds have the best performance record of any major sector of the fixed income universe for virtually every period through today. One would certainly expect these facts to attract buyers and raise prices.

In 1984, I was sure this market would become efficient in five years. But it hasn't done so ten years later, despite the high historic and prospective returns. **Why haven't enough buyers stepped forward to eliminate the excessive risk premium, render these bonds fairly priced and correct the inefficiency?**

The answer, we feel, is simple: **investors continue to be unfairly prejudiced against them**. Not every investor, clearly, but enough big players to create a buyers' market and tilt the opportunity in favor of those who are willing to participate.

Prove it, you say? Well, this memo was occasioned by an article in "Pensions & Investments" reporting consultant SEI's recommendation that pension plan sponsors invest 10% to 30% of their fixed income portfolios in high yield bonds. As I went through the article, my reaction was that it was a great selling piece for our market sector -- not just SEI's recommendation, but what the article demonstrated about investor attitudes.

According to the article, SEI feels "a sponsor could add about 20 basis points of return without adding risk by putting 10% of its fixed income portfolio in high yield, or junk, bonds." And that's after SEI "tried to be as conservative as possible in its assumptions." I'm sold! But the article goes on to show how a market can be biased against an asset class:

> . . . High yield is perceived as a way to add diversification, but is not well-received by clients. "Not a lot of our clients are opting to use them . . . . We work with some clients who just plain don't want them in their portfolio." (Callan)
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> Because of the negative publicity surrounding high yield bonds around the turn of the decade, plan sponsors either are wary of investing in them, or are afraid of being associated with them. (Pensions & Investments)
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> Some plan sponsors may be limited by plan guidelines to investment-grade securities, . . . Other sponsors may be wary of junk bonds because of the market's well-publicized collapse in 1989 and 1990, and the securities' association with Michael Milken and the now-defunct bond house Drexel Burnham Lambert. (SEI)

If we're going to worry about a collapse, I hope it'll be one looming ahead, not one which occurred five years ago. The asset class that collapsed in the past is likely to be cheap, not to be riding a crest of popularity and thus heading for a fall.

But too many investors drive looking in the rear-view mirror. As someone at my former place of employment once told clients, "We're buying the oils; they've been good to us." We'd rather buy what has performed badly or is the subject of negative bias and thus is cheap. We feel strongly that high yield bonds qualify today, and we'd be glad to talk more about them, or about the opportunities in other areas.