Memo to: Oaktree Clients

From: Howard Marks

Re: The Limits to Negativism

The markets acted on Monday as if the credit crisis is behind us – how incredible it is to be able to even write those words, whether true or not. Whichever is the case, however, it's important to reflect on what can be learned from the recent events. (I developed these thoughts last week but just wasn't quick enough to turn them into a memo. So I'm reduced to discussing what we all hope is history rather than displaying foresight.)

The Swing of Psychology

The last few weeks witnessed the greatest panic I've ever seen, as measured by its severity, the range of assets affected, its worldwide scope and the negativity of the accompanying tales of doom. I've been through market crashes before, but none attributed to the coming collapse of the world financial system.

It's worth noting that few of the recent sharp price declines were associated with weakness in the depreciating assets or the companies behind them. Rather, they were the result of market conditions brought on by psychology, technical developments and their interconnection. The worst of them reflected a spiral of declining security prices, mark-to-market tests, capital inadequacy, margin calls, forced selling and failures.

It was readily apparent that such a spiral was underway, and no one could see how or when it might end. **That was really the problem: no scenario was too negative to be credible, and any scenario incorporating an element of optimism was dismissed as Pollyannaish.**

There was an element of truth in this, of course: nothing was impossible. **But in dealing with the future, we must think about two things: (a) what might happen and (b) the probability it will happen.**

During the crisis, lots of bad things seemed possible, but that didn't mean they were going to happen. In times of crisis, people fail to make that distinction. Since we never know much about what the future holds – and in a crisis, with careening causes and consequences, certainly less than ever – we must decide which side of the debate is more likely to be profitable (or less likely to be wrong).

For forty years I've seen the manic-depressive cycle of investor psychology swing crazily: between fear and greed – we all know the refrain – but also between optimism and pessimism, and between credulity and skepticism. In general, following the beliefs of the herd – and swinging with the pendulum – will give you average performance in the long run and can get you killed at the extremes.

Two or three years ago, the world was so different as to be almost beyond remembering. It was ruled by greed, optimism and credulity. **In short, it was the opposite of the last few weeks: no story was too positive to be believed.**

- "There's a worldwide 'wall of liquidity' that can never dry up."
- "Triple-A CDOs are as safe as triple-A corporate debt but will deliver higher returns."
- "Leverage holds the key to better investment results."
- "Tranching and selling onward are spreading the risk, thereby eliminating it."
- "Decoupling has reduced nations' economic reliance on the U.S."

Boy, what a good time that was for a dose of skepticism! What benefits it could have provided (in terms of losses avoided). But when conventional wisdom is rosy, few can stand against it. People who do so too early look woefully wrong and are swept aside. That discourages others from trying the same thing, even as the cycle swings further to the positive extreme.

<u>The Black Swan</u>

You may recall that in "The Aviary" in May, I wrote about *The Black Swan*, the second book from Nassim Nicholas Taleb, author of *Fooled by Randomness*. In *The Black Swan*, Taleb talks about unlikely, extreme, unpredictable events that have the potential for dramatic impact. His title was derived from the fact that, never having traveled to Australia and seen its black swans, Europeans of a few centuries ago were convinced all swans were white. In other words, because they'd never seen something, they considered it impossible.

The message of *The Black Swan* is how important it is to realize that the things everyone rules out can still come to pass. That might be generalized into an understanding of the importance of skepticism.

I'd define skepticism as not believing what you're told or what "everyone" considers true. In my opinion, it's one of the most important requirements for successful investing. If you believe the story everyone else believes, you'll do what they do. Usually you'll buy at high prices and sell at lows. You'll fall for tales of the "silver bullet" capable of delivering high returns without risk. You'll buy what's been doing well and sell what's been doing poorly. And you'll suffer losses in crashes and miss out when things recover from bottoms. **In other words, you'll be a conformist, not a maverick (an overused word these days); a follower, not a contrarian.**

Skepticism is what it takes to look behind a balance sheet, the latest miracle of financial engineering or the can't-miss story. The idea being marketed by an investment banker or broker has been prettied up for presentation. And usually it's been doing well, making the tale more credible. **Only a skeptic can separate the things that sound good and are from the things that sound good and aren't.** The best investors I know exemplify this trait. It's an absolute necessity.

The White Swan

Most people probably took away from *The Black Swan* the same lessons I did (and the lessons mentioned in "The Aviary"): "unlikely" isn't the same as "impossible," and it's essential for investors to be able to get through the low spots.

Of course, it's improbable events that brought on the credit crisis. Lots of bad things happened that had been considered unlikely (if not impossible), and they happened at the same time, to investors who'd taken on significant leverage. So the easy explanation is that the people who were hurt in the credit crisis hadn't been skeptical – or pessimistic – enough.

But that triggered an epiphany: **Skepticism and pessimism aren't synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive.** I'll write some more on the subject, but it's really as simple as that.

Contrarianism – doing the opposite of what others do, or "leaning against the wind" – is essential for investment success. But as the credit crisis reached a peak last week, people succumbed to the wind rather than resisting. **I found very few who were optimistic; most were pessimistic to some degree**. Some became genuinely depressed – even a few great investors I know. Increasingly negative tales of the coming meltdown were exchanged via email. No one applied skepticism, or said "that horror story's unlikely to be true." Pessimism fed on itself. People's only concern was bullet-proofing their portfolios to get through the coming collapse, or raising enough cash to meet redemptions. The one thing they weren't doing last week was making aggressive bids for securities. So prices fell and fell – the old expression is "gapped down" – several points at a time.

The key – as usual – was to become skeptical of what "everyone" was saying and doing. One might have said, "Sure, the negative story may turn out to be true, but certainly it's priced into the market. So there's little to be gained from betting on it. On the other hand, if it turns out not to be true, the appreciation from today's depressed levels will be enormous. I buy!" **The negative story may have looked compelling, but it's the positive story – which few believed – that held, and still holds, the greater potential for profit.**

The Future

I write a lot to dissect and explain past events, but I'll try here to make a contribution by taking the riskier path of talking about the future. What do I see?

As for the short term, it's been amply demonstrated that governments and central banks will do everything they can to resolve the credit crisis. No stone will go unturned, and few options will be declined. Most people now believe that letting Lehman Brothers go was a big mistake: as a result of a calculated decision, discipline took precedence over rescue. The results were disastrous, as the commercial paper market froze up, money market funds "broke the buck," and the crisis was ratcheted up several notches.

Most people don't repeat their mistakes; they make new ones. So we should expect that all key players will be rescued in the period ahead. Some elements of that effort will be mistakes, but at least those mistakes won't pull down the financial system. Morgan Stanley was the next big worry but, after Lehman, it became unlikely that Morgan would be allowed to fail. I was asked, "Will the U.S. government guarantee a capital investment made by a Japanese institution?" Absolutely, if that's what it takes. It beats the U.S. having to put up its own money.

The sums being thrown around are the biggest ever: hundreds of billions, adding up to trillions. But there's no hesitation: everything will be done. That doesn't mean it has to work, but it's likely to.

Walter Wriston led Citibank from 1967 to 1984, all but my final year there. He was the world's leading banker and a great guy. One of his most famous observations was, "countries don't go bust." I assume he was making reference to their ownership of printing presses, and thus their unlimited ability to pay their local-currency obligations. That's the main reason why we shouldn't expect there to be any limit on the resources thrown at the problem. All it will take is running the printing presses long enough to rebuild financial institutions' capital accounts, make good guarantees and enable borrowers to roll over their outstanding debt, all of which is reckoned in nominal terms. **The philosophical bridge of unlimited aid to private institutions appears to have been crossed, and printing the necessary money is unlikely to be an issue.**

Of course, that doesn't mean we're out of the woods. **Creating money isn't the end of the story.** What will be the effect?

First, the people who have money have to make the decision to lend to those who need it to fund their businesses. The Fed's provision of capital to financial institutions – even at ultra-low interest rates – isn't enough. If banks borrow money cheaply and lend it to people who don't repay them, they'll be out a lot of low-cost capital. And if they're on the hook for repaying the Fed, they'll be way behind. Because of residual conservatism, the steps so far might have the ineffectiveness of "pushing on a string," something I mentioned in "Now What?" in January. We still have to see money begin to circulate throughout the system.

Jim Grant, the creator of *Grant's Interest Rate Observer*, uses a great phrase to describe liquidity and credit: "money of the mind." Unlike actual currency, it grows and shrinks depending on people's moods – we've just seen a great demonstration. So it's not enough for the Fed to give money to financial institutions; they have to be convinced to provide liquidity and credit.

In recent times, the Fed has provided a lot of capital to banks, but it has also taken in a lot of deposits from banks. We want to see the Fed's advance reloaned, not put on deposit. That's what it'll take to restart the credit machine.

Even when credit starts flowing again, however, I doubt things will return immediately to their old pace. Losses have been taken and capital destroyed, and more losses may still be incoming (ask yourself if home prices are finished going down). More importantly, psyches have been damaged: consumer psychology, lenders' willingness, even investor confidence – all have taken a beating. I doubt if things will bounce right back. There just won't be the same expansiveness. I'll stick with what I said in "Now What?"

> Undoubtedly, credit will be harder to obtain. Economic growth will slow: the question is whether it will remain slightly positive or go negative, satisfying the requirement for the label "recession." Regardless, positive thinking and thus risk taking are likely to be diminished. All I can say for sure is that the world will be less rosy in financial terms, and results are likely to be less positive than they otherwise would have been.

<u>Awash in Money</u>

In the longer term, we have to wonder about the effect on the world of a glut of newly printed dollars, sterling and euros. The reason owning printing presses makes repayment easy is that it lets a nation cheapen its currency. But one would think that more units of currency per unit of GDP means a debasement of the currency, and thus reduced purchasing power (read: higher inflation).

Walking along Hyde Park on Sunday, I saw a street vendor selling old stock certificates. Do you have any banknotes, I asked? Anything from the Weimar Republic? For the last few weeks, I've wanted to get some of those.

In Weimar Germany, the government enabled itself to pay World War I reparations by cheapening its currency . . . literally. So the 1,000 mark note I bought was simply over-stamped One Million Marks in red. Voila! Now we're all rich.

The mark fell from 60 to the U.S. dollar in early 1921 to 320 to the dollar in early 1922 and 8,000 to the dollar by the end of 1922. It's hard to believe, but according to Wikipedia (user-maintained and perhaps not always the most authoritative):

> In December 1923 the exchange rate was 4,200,000,000,000 Marks to 1 U.S. dollar. In 1923, the rate of inflation hit 3.25 x 10^6 percent per month (prices double every two days).
>
> One of the firms printing these [new 100 trillion Mark] notes submitted an invoice for 32,776,899,763,734,490,417.05 (3.28 x 10^{19}, or 33 quintillion) Marks. [That's not a misprint.]

Lord Keynes judged the situation this way:

> The inflationism of the currency systems of Europe has proceeded to extraordinary lengths. The various belligerent governments, unable, or too timid or too short-sighted to secure from loans or taxes the resources they required, have printed notes for the balance.

But it's not that easy. People with things to sell aren't that stupid. So instead of 1,000 marks, a goat now costs one million marks. That piece of paper used to be a thousand mark note – and now it's a million mark note – but it still buys the same goat.

The benefit to the government is that it's able to pay off its old nominal debts in currency of which it suddenly has a lot more . . . but which no longer has much purchasing power. So when repaid in the cheapened currency in 1923, the person to whom the government owed 1,000 marks can only buy one-thousandth of a goat – not a whole goat as in 1920.

My late friend Henry Reichmann was a boy then, working as a busboy in a restaurant in Berlin. He told me he used to be paid at lunchtime and immediately ran out to spend his salary, since it would buy less if he waited until after work to shop.

That's hyperinflation. Just as the Great Depression became a model during the credit crisis, Weimar Germany gives us something to think about regarding our new future. **I'm not smart enough to know what's coming, but I'm also not dumb enough to think a few government actions on Monday were enough to solve all our problems.** At best, we usually substitute one problem for another – usually one later on in lieu of today's.

I don't know what to do about this risk, whether it'll come home to roost, or to what extent. And I certainly don't think hyperinflation can be assigned a high enough probability to make it worth doing much about. But it may cause one to rethink holdings of low-yielding, flight-to-quality-elevated, long-term Treasurys.

The New Financial Order

My daughter Jane – the artistic member of the family – has developed a strong interest in politics and economics of late. (I think this is happening to young people all across the U.S., and it's a very favorable development.) On Saturday she called to ask what I thought about government ownership of banks.

First, I said, I thought it could make an important contribution to solving the short-term problem, and that's good.

Second, however, the U.S. has a strong tradition of government non-involvement in business, and we'd probably like to see it stay that way. "Nationalization" is a much dirtier word in America than in most other places (*International Herald Tribune* headline, October 14 – "Nationalization rule: Do it, but don't say it"). My preference, I told Jane, is for free enterprise with some adult supervision. When we make fundamental changes in the system, it's hard to foresee all the consequences. Consider these questions:

- Will legislators push bankers to make more loans to their constituents (remember Fannie and Freddie)?
- Will the banks have to lend to everyone, even weak borrowers? Will they be allowed to reject any applicants?
- Will they be prevented from foreclosing when mortgages are unpaid?
- Will they be deterred from financing "anti-social" investments like leveraged buyouts?
- Will they be limited in compensating executives? Will that make them less attractive as employers?
- Will bank employees worry about being penalized for errors of commission but not errors of omission?
- If so, will banks be staffed by people who are overly risk-averse? Will they lean toward saying "no"?
- Will capital be harder to come by, especially for smaller, younger companies?
- Will economic growth be slower than it otherwise would have been?
- Will non-government-owned banks be at a disadvantage because, as weaker credits, they'll have to pay more than the competition for their capital?

No one knows, but these questions deserve consideration. **Here's the underlying question: if the government's equity is non-voting, will that be enough to keep it out of the banks' affairs? It's far too soon to say (and hard to be completely optimistic).**

I continue to believe the financial sector of the future will be less leveraged, less risk-prone, less profitable, slower growing and more regulated. And that'll make it less exciting, less glamorous and less the employer of choice. But the beauty of the free-market system is that most developments entail plusses as well as minuses. **I've believed for many years that just as success carries within itself the seeds of failure (see 2003-08), so does failure carry the seeds of success.**

If the banks are made more bureaucratic and risk-averse – and less aggressive and competitive – I'm sure independent boutiques will arise and prosper. The model I have in mind is a forest fire: a year after, bright green shoots grow from the ashes; in fact, I think they're fertilized by the ashes. Think what a landscape like that means for advisory firms like Moelis, Evercore, Gleacher and Greenhill.

In a free-market environment, not even a good knock can keep aggressive people from responding to opportunities. The financial sector will look very different in ten years from what it was a year ago – and that won't be all bad.

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I find that I often end with a quote from Warren Buffett, and often it's the same one:

> The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.

But now I want to talk about the flip side: **When others conduct their affairs with excessive negativism, it's worth being positive.** When others love 'em, we should hate 'em. But when others hate 'em, we can love 'em.

In "The Tide Goes Out" in March, I listed the stages of both bull and bear markets. I said that in the terminal third stage of a bull market, everyone is convinced things will get better forever. The folly of joining that consensus is obvious; people who invest thinking there'll never be anything to worry about are sure to get hurt.

In the third stage of a bear market, on the other hand, everyone agrees things can only get worse. The risk in that – in terms of opportunity costs, or forgone profits – is equally clear**. There's no doubt in my mind that the bear market reached the third stage last week. That doesn't mean it can't decline further, or that a bull market's about to start. But it does mean the negatives are on the table, optimism is thoroughly lacking, and the greater long-term risk probably lies in not investing.**

The excesses, mistakes and foolishness of the 2003-2007 upward leg of the cycle were the greatest I've ever witnessed. So has been the resulting panic. The damage that's been done to security prices may be enough to correct for those excesses – or too much or too little. But certainly it's a good time to pick among the rubble.

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I want to take this opportunity to congratulate and thank my Oaktree colleagues for their ongoing steadfastness. There's a simple formula for taking maximum advantage of opportunities in a collapsing market:

(a) have a firm, well-reasoned estimate of an asset's intrinsic value;
(b) recognize when the asset's price falls below its value, and buy;
(c) average down if the price goes lower; and
(d) be right about the value.

Acumen and resolve are **both** essential. My colleagues continue to show both. In recent weeks our list of purchases has been long most days, and our list of sales almost non-existent. Where there's cash we've put a lot to work, averaging down aggressively, in what we think are great buys.

I also want to thank our clients for trusting us and sticking with us. As Bruce Karsh and I wrote ten days ago in a memo to investors in our Opportunities Funds for distressed debt, ". . . in a few years we'll reminisce together about how easy it was to take advantage of the bargains of 2008-09." Whether or not the worst of the crisis is now truly behind us, I continue to feel that way.

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