Memo to: Oaktree Clients

From: Howard Marks

Re: Us and Them

As a kid, I – and probably you – viewed the world in simple terms. There were good guys and bad guys. Americans and commies. Cops and robbers. Settlers and redcoats. The Dodgers I cheered for and the Yankees who always won. **Over time my view of the investment community has settled into an equally clear distinction: us and them.**

You've heard a lot from me about the difference between the "I know" school and the "I don't know" school, concepts I introduced in "What's It All About, Alpha?" (July 2001) and elaborated on in "The Realist's Creed" (May 2002). In the last few years it has become clear to me that "we" don't differ from "them" just in terms of how much we think we know about the future, but in many other ways as well.

<ins>Do You Know or Don't You?</ins>

Most of the investors I've met over the years have belonged to the "I know" school. This was particularly true in 1968-78, when I analyzed equities, and even in 1978-95, when I had switched to non-mainstream investments but still worked at equity-centric money management firms.

It's easy to identify members of the "I know" school:

- They think knowledge of the future direction of economies, interest rates, markets and widely followed mainstream stocks is essential for investment success.
- They're confident it can be achieved.
- They know they can do it.
- They're aware that lots of other people are trying to do it too, but they figure either (a) everyone can be successful at the same time, or (b) only a few can be, but they're among them.
- They're comfortable investing based on their opinions regarding the future.
- They're also glad to share their views with others, even though correct forecasts should be of such great value that no one would give them away gratis.
- They rarely look back to rigorously assess their record as forecasters.

"Confident" is the key word for describing members of this school. For the "I don't know" school, on the other hand, the word – especially when dealing with the macro-future – is "guarded." **Its adherents generally believe you can't know the future; you don't have to know the future; and the proper goal is to do the best possible job of investing in the absence of that knowledge.**

The Benefits of Membership

As a member of the "I know" school, you get to opine on the future (and maybe have people take notes). You may be sought out for your opinions and considered a desirable dinner guest . . . especially when the stock market's going up.

Join the "I don't know" school and the results are more mixed. You'll soon tire of saying "I don't know" to friends and strangers alike. After a while, even relatives will stop asking where you think the market's going. You'll never get to enjoy that 1-in-1,000 moment when your forecast comes true and the Wall Street Journal runs your picture. On the other hand, you'll be spared all those times when forecasts miss the mark, as well as the losses that can result from investing based on over-rated knowledge of the future. **But how do you think it feels to have prospective clients ask about your investment outlook and have to say, "I have no idea"?**

For me, the bottom line on which school is best comes from the late Stanford behaviorist, Amos Tversky: **"It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on."**

"A group of related or coincident things, events, actions, etc."

Random House's secondary definition for the word "syndrome," shown above, suggests a set of elements that can be viewed separately but take on greater meaning when considered together. **And the more I think about it, the more I see such a pattern in the contrasting styles of investment industry participants.**

Investors don't just differ in regard to their views on foreknowledge, but in terms of a large number of elements. And the pattern among those elements seems to be consistent – correlated – not random. Ask yourself, for example, whether the "I don't know" school is evenly divided between bulls and bears. Maybe, but in my experience, members of the "I don't know" school tend to trust less in the market than those of the "I know" school. That's an example of the pattern, or syndrome, that I think investors tend to demonstrate in many regards.

In my memo "Returns and How They Get That Way" (November 2002), I gave examples from a brilliant dichotomization propounded by Nicholas Taleeb. His book, "Fooled By Randomness," has as its theme the pervasive role of luck in investing and the tendency of people to overlook its effect. He provides a table that shows a number of things in the first column that can easily be mistaken for things in the second column.

Luck	Skill
Randomness	Determinism
Probability	Certainty
Belief, conjecture	Knowledge, certitude
Theory	Reality
Anecdote, coincidence	Causality, law
Survivorship bias	Market outperformance
Lucky idiot	Skilled investor

My point here, and my reason for reproducing part of Taleeb's table, is my belief that **there are people who see the things on the left, and there are people who see the things on the right, but few who see some of each**. Some people think their ability to infer causality and analyze data makes them skilled investors capable of producing consistent outperformance. Others understand that luck plays a big part; that a lot of apparent causality is really coincidence; and that the person crowned the most skilled investor in a given year might be nothing more than a "lucky idiot." Very few people mix aspects from both columns.

I can think of many qualities that seem to go together to define one of the two main types of investor but not the other. I'll discuss them below and attribute them to either the "Oaktree-style" investors with whom I tend to associate – "us" – or the other sort of investor – "them."

<u>Personality Type</u>

It would be great to either be middle-of-the-road and dispassionate all the time or, better yet, bullish or bearish at just the right time. But few people can achieve either of those ideals. Most investors are congenitally either bullish or bearish, and I've never seen anyone capable of flipping in an adroit and timely manner from one to the other. For most of us, it's either bullish most of the time or bearish most of the time – right or wrong.

For many of the outstanding investors I've come across, it's the latter. And I shouldn't say bearish – I've just used that word as shorthand for a number of others. But the "us-style" investor tends to be cautious and defensive, while the "they-style" investor tends to be optimistic, confident and aggressive.

And the investors I like most are patient. Because they know they can't be right every time, their real concern is with the long run. On the other hand, the "I know" investor feels he has a good handle on what lies ahead and thus plans to do an above-average job every year – an admirable goal, perhaps, but I don't think highly achievable.

<u>Hunt for Upside or Avoid Downside?</u>

One of the most significant ways in which these differences manifest themselves is in terms of attitude toward risk. If you're confident that you know what the future holds, risk isn't frightening. But if you're convinced that you don't have that good a handle on the future, it's hard to be very cocky.

Our kind of investor is preoccupied by risk, whereas I think the other is often oblivious to it. Our kind worries about what can go wrong, while the other revels in what might go right. Ours tries to avoid mistakes, and the other concentrates on finding winners. **Ours obsesses about the losers he might buy or hold, while the other dwells on the opportunities he might miss.** In short, it's offense versus defense.

Other Aspects of Investment Style

The optimist tends more often than not to be a growth investor; he's confident that above-average growth can be perpetuated and that he can identify the companies that'll do so. The more cautious investor looks for value – for tangible attributes that can be counted on for price support even if confidence in the company proves to be unwarranted.

Our school of investing puts great emphasis on being a contrarian. If you want to buy something of solid value, and you want to buy it for less than it's worth, you'll have a better chance if you look among assets, companies and markets that are out of favor. Thus we're happiest when we're not part of the herd; we prefer to watch the herd's extreme boom-bust behavior and profit from its mistakes. Most other investors seem to be happy when they're part of the herd and following the trend.

Our kind of investor likes to average down. He holds a firm view of his securities' value and wants to increase his holdings at lower prices. Thus he likes to see prices decline (although he's not cocky enough to completely dismiss the possibility that the market's right rather than him). The trend follower wants to see appreciation and is disheartened by initial declines. In fact, I think he prefers to average up as appreciation validates his thesis.

Certain that his forecasts are right and his portfolio is properly positioned, the "I know" investor wants to let his profits ride. The "I don't know" investor is painfully aware of how much he doesn't know; how much of his performance is beyond his control; that good fortune may have contributed to his results to date; and that events can easily turn against him. Thus he's happy taking profits and banking some of his gains. If appreciation occurs beyond his expectations, it makes him stop and think . . . and maybe sell, not just celebrate.

The "we" investor is comfortable holding cash when he can't find attractive investments. At the present time, a number of the investors I most respect are holding or returning significant amounts of cash, or closing their funds. The confident "them" investor is pained by cash – he thinks he always should be able to find something worth buying. And he tends to be more relative-return oriented, and thus worried that an index or competitor might beat him if he isn't fully invested.

I see an extreme dichotomy in the fact that the "us" investor worries about losing money, while the other worries about underperforming. (I can't claim to be 100% the former, because I – and most of Oaktree's clients – think that in the long run, the best manager is the one who beats the others. That's something that's hard to argue with. But my desire for relative performance doesn't make me comfortable with losses.)

Lastly, because the "I don't know" investor is highly conscious of his limitations, he is likely to aggressively limit his assets under management. Most of the "I know" investors, who tend to work in the more liquid mainstream markets, never met a dollar of AUM they didn't like – or didn't feel they could achieve great things with.

Attitudes Toward the Market

The actions of "they" investors are often driven by their views regarding the outlook for the market. They invest more aggressively when the outlook's positive than they do when it's negative (although, as I said before, they're usually positive). "We" investors tend to invest from the bottom up, primarily basing investment decisions on whether attractive individual investment opportunities are available.

In fact, I'm often struck by the fact that "they" are preoccupied with studying and assessing the behavior of "the market" – which collectively means studying themselves. My favorite investors – both inside and outside Oaktree – spend their time almost exclusively looking into individual companies and their securities.

One of the greatest dichotomies is that "they" impute intelligence to the market while "we" are highly skeptical of it. Trillions of dollars were lost after 1998-99 because the mass of investors hadn't sufficiently questioned the valuations of tech stocks. They'd been told, "The market's efficient" and assumed that if a stock was selling at a price, that meant the price was justified. **The investors I respect feel the market's often wrong – either underpricing or overpricing securities – and more than anything else, they look for opportunities to profit from those errors. In their view, as Dickens said about the law, "the market's an ass."**

So Where Do We Stand Today?

The market is a big arena where optimists and pessimists engage in a tug of war. When optimism is rising relative to pessimism, meaning more money wants to get put to work than wants to exit, prices rise (and vice versa). The market has been going roughly sideways for the last few months, meaning the two camps are in rough balance. **But that doesn't mean they're not both out there.**

Everyone had a great year in 2003, and "they" seem to think it's going to continue. They're cheered by signs of economic recovery, corporate profit gains and job growth. "We," on the other hand, worry about the things that could result in disappointment, like the lackluster economic and employment gains, and the trade and budget deficits. We also worry about structural issues, such as the US's reliance on foreign capital, the questionable outlook for the dollar, and the consumer's high level of indebtedness and low level of savings. Lastly, we feel the possibility of domestic terrorism hangs out there like a sword of Damocles.

A particularly striking difference can be seen in current attitudes toward interest rates. Rates do a great deal to influence the vitality of the economy and the price and relative attractiveness of market sectors. Today's low rates encourage growth and borrowing. They also reduce the competition to stocks posed by bonds and money market securities. Finally, since interest rates are used in present value calculations to discount future cash flows, lower interest rates result in higher valuations for all assets.

Obviously, then, today's record low rates go a long way to explaining what's going on in the investment world. With money market securities yielding 1% and Treasury notes at 3-4%, yields of 6-8% on high yield bonds look attractive; market-neutral hedge funds look like a bonanza at 9-11%; and expectations of 15-20% are enough to attract money to private equity (rather than the old 25-30%). Just as importantly, low interest rates lower the hurdle return for equities and justify p/e ratios in the high 20s.

What sums it up is the line that "stocks aren't overpriced given the current level of interest rates." "They" derive comfort from the fact that today's valuations are consistent with today's rates, while "we" worry about the impact on valuations that a rise in rates would have.

Rates can't go down all that much, but there's plenty of room for them to go up. (I still have the framed notice from 1980 telling me that the rate on my bank loan had reached 22¼%!) **That tells me that p/e ratios can't rationally go up much more but there's plenty of room for them to go down**. And if we ignore the threat of a rate rise and merely assume that rates will hold steady, the resulting return on the average stock would be just in line with normal profits growth in mid-single digits.

So the optimist is cheered by the low rates (and their stimulative power), and the pessimist is concerned about the risk implicit in a possible rate rise. **Or, as it seems to me, "we" worry about valuations and "they" feel comfortable on the subject . . . as usual.**

<u>How About an Example</u>

Rather than hold up my Oaktree colleagues as exemplars of astute "us-style" investors (which I think they are), I'd like to propose an unnamed investor for your consideration. I'll tick off his credentials for inclusion (as I see them) and throw in a few quotes from his recent writings.

- He never bases his investment actions on forecasts for the economy or market. ". . . the cemetery for seers has a huge section set aside for macro forecasters. We have in fact made few macro forecasts . . , and we have seldom seen others make them with sustained success."

- Rather, his actions are strictly determined by the availability of attractive investment opportunities. "Under *any* market or economic conditions, we will be happy to buy businesses that meet our standards."

- He's a solid investor in value – be it derived from current cash flow, unique market position or special human resources.

- Because of his risk awareness and desire to avoid losers, **he always insists on a generous "margin of safety."**

- He is absolutely unconcerned if an index or competitor outperforms him for a year or two, but he insists on avoiding losses. **Losing less than his competitors is not his definition of success.**

- When attractive investment opportunities are few, he's willing to stand at the plate with the bat on his shoulder – something he says he's doing a lot of nowadays. In 2003, that caused his holdings of cash to triple. **"Our capital is underutilized now . . . . It's a painful condition to be in – but not as painful as doing something stupid."**

- He seems happiest when betting against the herd. For example, on the subject of distressed bonds, he says "yesterday's weeds" (which yielded 30-50% in 2002), are being priced as "today's flowers" (and thus yielding 4-6%). He's written me that he "liked them better when they were weeds."

- Certainly he's a patient long-term investor (and, in fact, not much of a profit taker; he recently expressed some regret about having not sold during The Great Bubble).

- He is very conscious of the effect of increased capital on investment returns. "When [a manager] tells you that increased funds won't hurt his investment performance, step back: His nose is about to grow."

There are lots of ways to skin the cat, and certainly there are successful investors among "them." **But the characteristics enumerated above have provided the foundation for Warren Buffett's incredible record, and that makes them good enough for me.**

* * *

To help you see the picture I'm suggesting and evaluate the investors you come across, I've prepared the quick-and-dirty checklist that appears on the following page. Few people will hit every point on the head, but I think you'll recognize in the list on the left a lot of the "they" school investors you know, and on the right, hopefully, a few from the "us" school. **Each year – especially in good times – the headlines will go to those on the left who guess correctly. But in the long run I think it's people on the right who'll be celebrated most.**

In today's trend toward hedge funds, I see a growing preference – whether conscious or unconscious – for "us" investors over "them." Consistent, risk-conscious, non-market-based investing is enjoying great popularity right now. I've considered it the ticket for almost three decades.

And by the way, I have one last thing to say: **vive la difference!!** In order for us to be contrarians, there has to be someone to be contrary to. If everyone invested our way, the opportunities we prize would be few and far between. **The best opportunities for investment returns aren't created by companies, exchanges or paper securities; they result from the mistakes other investors make. It's Oaktree's job to take advantage of them.**

May 7, 2004

P.s.: As I wrote this memo, one thing pained me, and I want to address it: I found myself constantly writing "he," even though I absolutely do not think investing skill is gender-related. It's just that I hate the thought of using "he/she" each time. (My son Andrew's school uses s/he.) And I find ungrammatical today's popular, gender-neutral formulation that "the top-performing investor finds that their gains come from hard work" – a plural pronoun substituting for a singular noun. So please bear with me; I'm really an equal opportunity memo writer.

THEM	US
"I know"	"I don't know"
Bullish by nature	Bearish by nature
Aggressive	Defensive
Confident	Guarded
Comfortable with risk	Obsessed with risk
What might go right?	What might go wrong?
Worried about winners missed	Worried about losers bought
Trend followers	Contrarians
Attracted to pretty flowers	Glad to search among the weeds
Comfortable when part of the crowd	Happy when apart from the crowd
Growth/momentum investors	Value investors
"Great things cost a lot"	Insistent on buying cheap
Believers	Skeptics
"We're in a new era"	"Trees don't grow to the sky"
Cheered by appreciation	Frightened by excessive appreciation
Enjoy averaging up	Enjoy averaging down
"Let it ride"	Eager to take profits
Relative return-oriented	Absolute return-oriented
Worried about underperforming	Worried about losing money
Pained by cash	Comfortable with cash
Confident in their powers	Aware that much is beyond their control
Convinced that their good returns are fully deserved	Highly conscious of the role played by luck
Impatient	Patient
Short term-fixated	Long term-oriented
Never worried by large amounts of capital	Aware that it's possible to have too much capital
Engrossed in watching the market	Devoted to watching companies
"The market's efficient"	"The market's an ass"

Everything's okay:	Worries abound:
Economic recovery underway	Movement of jobs overseas
Corporate profit gains	Gaping trade deficit
Increases in productivity	Growing budget deficit
Continuing foreign investment	Reliance on foreign capital
Ability of weak dollar to bolster exports	Threat to value of the dollar
Existence of job growth	Halting nature of job growth
Optimism implied by willingness to borrow	Consumers' high debt/low savings
Strong military capability	Risk of terrorism
Low level of interest rates	Risk of interest rate rise
Today's security prices are justified by low rates	Today's security prices are reliant on rates staying low