Memo to: Oaktree Clients and Friends

From: Howard Marks

Re: Will It Be Different This Time?

One of my favorite articles, "Why This Market Cycle Isn't Different" by Anise C. Wallace, appeared in the New York Times. It skeptically recounted the rationale being advanced why a traditional correction of the stock market's meteoric rise need not take place. Among the reasons cited were (1) the outlook for continued economic growth, given that the economy had learned how to correct itself painlessly, (2) hope for return to a gold standard, (3) optimism regarding world peace, (4) the likelihood of continued buying of U.S. stocks by foreign investors piling up dollars with no better place to go, and (5) the fact that stocks were not overvalued compared to other assets, which had also appreciated.

This was the optimists' argument. But its flaws became apparent almost immediately after the article was published ... **on October 11, 1987**. By the close on October 19, the market had fallen by 30%. So much for the bulls' predictions!!

And so much for predicting a future markedly different from the past. The article pointed out that some of the arguments did have some truth to them, but it also cited John Templeton's assessment that people who say things will be different are right only one time out of five. The hard part is knowing which times those are.

All of this was called to mind ten days ago by an article on the front page of the Wall Street Journal. Entitled "The Business Cycle is Tamed, Many Say, Alarming Others," it recounts the case currently being made for this remaining a continuous, recession-free economic expansion. As its lead paragraph says,

> From boardrooms to living rooms and from government offices to trading floors, a new consensus is emerging: The big, bad business cycle has been tamed.

The current expansion, at 67 months, has already far exceeded the postwar average. Nevertheless, 51 of the 53 "top economists" surveyed by Blue Chip newsletter (my favorite experts and the subject of my July 22, 1996 memo) predict growth next year of 1.5% or more. And the University of Michigan survey finds that among consumers, more expect five more good years than expect bad times to emerge.

The Chairman of Sears states "There is no natural law that says we have to have a recession." According to Amoco's Chairman, "I don't see any reason to believe [the recovery] can't go on until the turn of the century." Sara Lee's CEO says "I don't know what could happen to make a cyclical downturn." (For a few more quotes like these, see page three.)

The article goes on to cite the arguments behind this year's version of "this time it'll be different." First, because the recovery has been wishy-washy to date, there is no "boom" to "bust." Second, today's enhanced pace of business has been accommodated more through flexibility and efficiency than through brick-and-mortar expansion and inventory building. Third, the service economy has largely supplanted the more cyclical manufacturing sector. Fourth, globalization of the economy will enhance geographic diversification and provide new sources of demand for goods.

Similarly, we all hear lots of reasons why today's high stock market valuations aren't dangerous and no correction is required. These include the inevitability of 401(k) inflows; the steadfastness of mutual fund investors; the shortage of stocks which will result from corporate buybacks (in 1987, the shortage was going to result from the privatization of companies via leveraged buyouts); the vast opportunities presented by technology and the Internet; the improved profit stance of business after years of downsizing and cost-cutting; the fiscal responsibility imposed on government and the resulting favorable outlook for the deficit; and the irrelevance of dividend yield and other traditional valuation parameters. As always, the list appears to grow longer as higher levels are reached on the Dow.

But I recoil any time I hear a prediction that trees will grow to the sky, or that centuries of history are irrelevant. When I hear people say the valuation measures of the past no longer matter, I think John Kenneth Galbraith put it well, stating that in a speculative episode,

> Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present. (<u>A Short History of Financial Euphoria</u>, Viking, 1990)

And I feel cyclicality is one of the few constants in the economy and markets. Cycles are the result of human behavior, herd instinct and the tendency to psychological excesses, and these things are unlikely to evaporate. Galbraith cites "the extreme brevity of the financial memory" in explaining why markets are able to move to extremes of euphoria and panic. And few adages have been borne out as often as "What the wise man does in the beginning, the fool does in the end." It is rare for trends to be curtailed at a reasonable point before swinging to the excesses from which they invariably correct.

Today, there are some signs just as worrisome as the bullish arguments are constructive. We detect the decline of skepticism and discipline and the aggressive extension of credit which regularly precede corrections. Capacity expansion has been strong in some industries, and construction seems about to resume. Consumer debt, default and bankruptcy are all at high levels. Prices being paid in acquisitions are once again high. There's too much money chasing too few deals. The stock market is exhibiting unusually narrow "breadth" (e.g., with the Dow up 76 points today to 6547, another record, half of all stocks were unchanged or down). Every cocktail party guest and cab driver just wants to talk about hot stocks and funds.

And there's a final factor I want to mention: capitulation. This is the word I use to describe investor behavior late in cycles. Investors hold to their convictions as long as they can, but when the economic and psychological pressures become irresistible, they surrender and jump on the bandwagon. Given years of above-average performance by stocks, many investors are now increasing their commitments to equities. A few weeks ago, we learned of an extreme example, a foundation whose long-term 80% allocation to bonds had been shown to be sorely out of step, so it threw in the towel and went **100% to equities.** Capitulation like this adds to the strength of the trend (for a while), but it also increases the level of danger. First, it indicates the advanced age of the cycle; second, it can cause investors to take positions for which they are unsuited; and third, when the last investor has taken his or her maximum equity position, who's left to power a subsequent rise?

As you know, we don't consider ourselves good macro-forecasters (or even people who believe in forecasting). So we certainly are in no position to say when the recession or market pullback will start, how bad it will be...or even that there definitely will be one. But we think we're unlikely to be proved wrong if we say cyclicality is not at an end but rather is endemic to all markets, and that every up leg will be followed by a down leg.

In 1988, when we marketed our first distressed debt fund, the greatest obstacle we faced was a somewhat widespread belief that there would be no recession and we'd have nothing to do. The theory then was that because of "rolling corrections" of individual industries and regions, the entire economy would never again decline all at once. The Times's 1987 article said that according to some investors, "the prolonged slow-growth environment would not necessarily be followed by a recession." But, of course, a recession did develop in 1990 (one of the worst since the Depression), we got very busy in distressed debt, and that 1988 fund produced a gross return of 29% per year.

So we conclude that most of the time, the future will look a lot like the past, with both up cycles and down cycles. There is a right time to argue that things will be better, and that's when the market is on its backside and everyone else is selling things at giveaway prices. It's dangerous when the market's at record levels to reach for a positive rationalization that has never held true in the past. But it's been done before, and it'll be done again.

> "There will be no interruption of our present prosperity."[1]
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> "I cannot help but raise a dissenting voice to the statements that ... prosperity in this country must necessarily diminish and recede in the future."[2]
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> "We are only at the beginning of a period that will go down in history as the golden age."[3]
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> "The fundamental business of the country ... is on a sound and prosperous basis."[4]

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[1] Myron E. Forbes, President, Pierce Arrow Motor Car Co., January 1, 1928
[2] E.H.H. Simmons, President, New York Stock Exchange, January 12, 1928
[3] Irving T. Bush, President, Bush Terminal Co., November 15, 1928
[4] President Herbert Hoover, October 25, 1929

source: Oh Yeah?, Viking Press, 1932

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In the interest of full disclosure, I want to mention here that I've been contemplating the possibility that my views on these matters are too cautious and short-sighted. My conclusion is that I am a product of my experience.

Many of us were raised by parents whose views were heavily influenced by living through the Depression. Likewise, I was baptized under fire during my first five years in the investment industry, when the shares of the best companies in America -- the "nifty-fifty" -- dropped 70% to 90% in the early 1970s and then the entire market lost roughly half its value in 1973-74.

You have to be more than forty-five years old to have been in the business during that last real bear market in 1973-74. I've heard it said that today "everyone over forty is terrified by the market, but most of the people running money are under forty." There's a lot of truth to this, and it's interesting to note that relatively few of today's investment professionals are in their mid-to-late forties, a scarcity caused by the tough times in the industry in the 1970s and the resultant lack of hiring.

Maybe I spend too much of my time worrying about the next bear market; I've been conditioned to do that. And maybe I'm wrong. But Oaktree's clients needn't worry that we'll manage their portfolios based on the assumption that a correction is imminent. We believe strongly that "it's one thing to have an opinion but quite another thing to act as if it's right." So while we take some defensive steps in portfolios as our caution grows, we're always fully invested and just as ready for a market rise as we are for a decline.

The bottom line for us is that **if Oaktree can continue to match and beat the indices in our inefficient markets despite an overlay of protection against risk that could prove unneeded, I think we're adding real value**. That has been our history, and it certainly remains our goal.

November 25, 1996