

Memo to: Oaktree Clients

From: Howard Marks

Re: The Role of Confidence

Confidence is generally defined as belief in one's ability to choose a course of action and execute on it. Although it's not part of the definitions I've consulted, I think confidence also connotes optimism (at least it does among investors). Finally, there's an element of certainty: beyond an optimistic view of the future, there's conviction that view is correct. **Taken together, the ingredients I see in confidence – belief, optimism and certainty – combine to create a feeling of well-being. Confident investors are sure big returns lie ahead.**

The Confidence Effect

The so-called “wealth effect” plays an important and well recognized part in the functioning of an economy. In short, when assets appreciate in value, the owners of those assets translate their increased wealth into increased spending. While at first glance this is unsurprising, it should be noted that this is true even if the appreciation is unrealized, and thus the increased wealth exists solely on paper. The relationship can be simply stated as follows: the richer people feel, the more they spend.

Changes in confidence have an impact on behavior similar to the wealth effect. That's what this memo is about.

I have long been impressed by the role of confidence in an economy. In fact, I've written in the past – exaggerating only slightly – that sometimes I think confidence is all that matters. I consider its impact to be significant, pervasive, self-reinforcing and self-fulfilling.

The primary impact of confidence on the economy is simple. **If people think the economic future will be good, they'll spend and invest . . . thus things will be good.**

- Consumers' optimism will translate into incremental demand for goods, adding to GDP.
- Consumer buying will convince businesses to invest in expanded facilities and additional workers in order to keep up with growing demand.
- Businesses' investment in plant and workers will add to GDP.
- Newly hired workers will have money to spend, and their buying will add further to the cycle.
- The reports of confidence-fueled increases in GDP and other positive mentions of the economy in the media will reinforce this virtuous circle of optimism: back to step one.

So, just like the wealth effect, increased confidence makes people and businesses spend more, and this in turn cycles back into the economy. **Confidence leads to spending; spending**

strengthens the economy; and economic strength buttresses confidence. It's a circular, self-fulfilling prophecy.

Confidence can also fuel market movements. Belief that the price of an asset will rise causes people to buy the asset . . . making its price rise. This is another way in which confidence is self-fulfilling.

Of course, the confidence that underlies economic gains and price increases only has an impact as long as it exists. Once it dies, its effect turns out to be far from permanent. As the economist Herb Stein said, "If something cannot go on forever, it will stop." This is certainly true for confidence and its influence.

Confidence Today

Back in September, I wrote a memo entitled "On Uncertain Ground." It began as follows: "The world seems more uncertain today than at any other time in my life." I went on to review the many elements contributing to uncertainty. For the sake of completeness, I'm going to restate and update my list. These are things I'm asked about all the time. I don't recall another time when the list was as long:

In the U.S.:

- Will the recovery from the recession of 2008 – long in the tooth but still halting and unsteady – ever gain vitality? Today it seems we're experiencing "two steps forward, one step back," as positive reports are regularly mixed with disappointments. Further, even the improvements – in areas like job creation, consumer confidence and manufacturing output – seem tepid rather than eye-popping. This is quite different from the recoveries of the last few decades.
- To what extent will the recovery be impaired by recent tax increases and the budget cuts mandated by "sequestration"?
- When will sales increases overcome businesses' resistance to spending on plant and personnel?
- How much longer will the Fed keep interest rates low? Three months? Three years? In perpetuity?
- What will happen when it no longer does? Will rates rise? How much? Will the effect of higher rates on the cost of financing purchases and investments be enough to slow the economy? And what will be the impact of higher rates on the government's cost of financing, and thus on the deficit?
- What are the implications of the fact that the Fed's balance sheet has swelled to over \$3 trillion? How does the Fed pay for the bonds it buys under QE? Will it have to pay that money back? Will the Treasury have to pay off the Fed when the debt matures? Where will it get the money? And where will the money go? (Think about this for a minute: do you feel you understand the workings of this process? Do you know anyone who does?)
- Will our economy ever get back to the higher growth rates of the late twentieth century, or will we be stuck in a slow-growth mode?

- Will “structural unemployment” in the future remain stubbornly above the 5% or so of the last few decades?
- Will profit margins retreat from their current record levels, and if so, what will be the effect on corporate profits?
- Longer term, can progress ever be made on cutting the budget deficit and reducing the unfunded entitlement obligations?
- What will be the social ramifications of slow growth, high unemployment and increased income disparity?
- Will the U.S. devalue the dollar, the usual path to dealing with excessive national debt?
- Will slow growth lead to Japan-style deflation? Or will high-volume money printing to make it easier to repay the debt bring on chronic inflation? (The mere fact that intelligent people worry simultaneously about both these polar opposites is in itself an indicator of the high level of uncertainty that is present.)

In Europe:

- Can the seeming downward spiral in peripheral Europe’s economies be arrested?
- Can Europe’s excessive indebtedness be brought down, and can the chronic deficits that led to that level of indebtedness be trimmed through austerity?
- Will richer nations continue to support poorer without insisting on the latter applying painful austerity?
- In practical terms, can austerity be undertaken at a time of economic weakness? If austerity is continued, are recession, suffering and unrest unavoidable?
- Won’t voters demand isolationism in the richer nations and relief from the pain of austerity in the poorer nations? Won’t elected leaders offering anything else be ousted?
- Will the highly restrictive regulations and labor laws be eased so as to enable Europe to compete on an equal footing with the rest of the world?
- Longer term, will the nations of Europe give a central body the control over economies and financial institutions required for an effective economic union?
- Will UK voters vote in the coming referendum to stay in the European Union or leave?
- Will the EU remain intact? Is a political union in which actions require unanimous support practical? Can governance and coordination be improved?

Regarding Leadership:

- Are there leaders – anywhere in the world – of the caliber we need to see us through these uncertain times?
- Can officials who seek re-election first and foremost rise to the occasion and make the tough decisions needed to apply unpopular solutions to problems, rather than palliative Band-Aids?
- Will the successors to Geithner and Bernanke prove up to the task of continuing the recovery while weaning the economy from ultra-low interest rates?
- Is it conceivable that America’s elected leaders will create an environment in which uncertainty over taxation, regulation and healthcare costs no longer discourages businesses from investing in plant and personnel?

Miscellany:

- Will China's credit-abetted economy experience a hard landing or a soft one?
- If China's growth slows, what will be the effect on nations such as Brazil, Australia and Canada that have prospered by supplying it with commodities? What will happen to commodity prices?
- Will Prime Minister Abe's monetary and fiscal program be enough to wake Japan's economy from its lethargy?
- Will fracking allow the U.S. to achieve energy self-sufficiency? If so, what will that do to its manufacturing competitiveness and to the price of oil?
- What will happen in hot spots such as the Middle East, Iran and North Korea?

Significant uncertainty is one of the outstanding characteristics of today's investing environment. It discourages optimism regarding the future and limits investors' certainty that the future is knowable and controllable. In other words, it saps confidence. **This is a major difference from conditions in the pre-crisis years.**

Confidence in 2007

When I think about how the investment environment of today differs from earlier times, the greatest change of all jumps out at me. Let's go back to just before the onset of the sub-prime crisis in mid-2007. I think in those days most people were 100% certain they knew:

- what made the global economy tick,
- what the economic and business world would look like in five or ten years, and
- what it would take to fix something that went wrong.

Belief in the things listed above largely eliminated uncertainty regarding the future and contributed to an extremely high level of confidence. No one thinks that way today.

Confidence: Good or Bad?

Let's say I have accurately described that confidence, optimism and certainty were high in 2007 and low in 2013. **Here's a key question that I've been wrestling with: which is more desirable?**

The answer is largely a function of your timeframe. The high level of confidence in 2007 – not unlike that of the 1990s – contributed to a feeling of great well-being. **The feeling that nothing would go wrong – that a perpetual-motion machine could be counted on to keep things on an upward course forever – contributed to rampant consumer optimism, aggressive spending, rising economic aggregates, accommodative capital markets and strong asset prices.** It sure felt good.

But was it desirable? It was not, in my view, because hindsight shows perception to have been very much out of proportion with reality, and thus dangerous:

- Consumer confidence, and thus spending, was too high relative to incomes.
- Excessive spending – all around the world, at all economic levels – led to excessive use of credit, making the world highly overleveraged.
- Buying fueled by confidence and leverage caused asset prices to rise out of proportion to value.

I often say the riskiest thing in the world is widespread belief that there's no risk. And certainly that was the prevailing condition in the pre-crisis years of 2005-07, as well as during the tech bubble of the late 1990s. In both instances the "era of well-being" was followed by a significant economic slowdown and market decline.

A feel-good environment characterized by strong confidence creates pleasant current conditions but encourages dangerous behavior and an ascent (in the economy and the markets) from which a correction becomes inevitable. In that way, the less confident attitudes of 2013 create a lackluster, less enjoyable environment, but also a preferable and more prudent base for the future. (The wild card, as described in "Ditto," January 7, 2013, is that the actions of central banks to lower interest rates have caused even unconfident investors to engage in pro-risk behavior, setting the stage for the market declines of June and perhaps for additional pain in the future.)

I've previously told the story of having been in New York on 9/11, and of requiring several days to get back to Los Angeles. When I eventually reached home, my son Andrew asked me, "Dad, is the world less safe than it used to be?" My answer was, "Maybe it's less safe than it used to be, or maybe it was never as safe as everyone thought it was." **Certainly it's healthier to recognize and accept uncertainty than to act as if the world is a safe place if it's not. That goes double for the world of investing.**

The Pendulum in Confidence

I probably write more about the pendulum of investor psychology than I do anything else. It was the subject of my second memo, in 1991, and my belief in its impact has grown unabated ever since.

The pendulum swings with regard to many facets of the market, and it often swings to extremes:

- between optimism and pessimism,
- between greed and fear,
- between euphoria and depression,
- between credulousness and skepticism,
- between risk tolerance and risk aversion, and thus
- between reckless aggressiveness and excessive caution.

While the pendulum moves with regard to all these things, the swinging movement, the extent and the error all reflect common themes. They're all examples of the ways in which, as Mark Twain said, history rhymes.

Let's take for an example one regard in which the pendulum swings: investor attitudes toward emerging markets. Sometimes they're considered scary and exotic places, and sometimes they're the attractive high-growth alternative to the stagnant developed world. When people have confidence in the emerging markets and see only their virtues, the stocks sell at U.S.-style p/e ratios (where they're described as being cheap given the superior growth rates). But when problems emerge and confidence falters, investors will only buy emerging market stocks at discount p/e's so as to have the benefit of the risk premiums they consider necessary. I've seen this swing – just like the others – numerous times.

I'm thinking back to 1994, when NAFTA was enacted, easing trade in North America. People were in awe of Mexico: "It's just like the U.S., but it grows much faster." So money flowed to Mexican stocks, and they boomed. But then, in short order, there occurred a revolt in the state of Chiapas, the assassination of a presidential candidate, and the devaluation of the Mexican peso, triggering the so-called "Tequila Crisis." And the pendulum swung back toward concern: "Oh, right – there are differences."

And just a few years ago, the consensus of investors held that it was all over for the developed world, and China was the only economy with potential thanks to its growing population, low labor costs and expanding consumer class. As a result there was too much confidence in China and too little in the rest of the world. China does have many advantages, and the problems of the developed world aren't imaginary. But that doesn't mean Chinese equities are worth the moon and developed world equities are without value. So after Chinese stocks did much better than developed world stocks in 2009, they were primed for subsequent underperformance.

Now with China reporting slower growth – and with the threat of reduced bond buying by the Fed eating into expectations for growth worldwide (and, with it, demand for China's exports) – confidence in China has receded. As a hedge fund strategist said in *The Wall Street Journal* on July 15, "It's not all sunshine in emerging markets anymore."

Summing up, I think it's fair to say one of the key swings of the investment pendulum is between too much confidence and too little.

- At the positive extreme, people believe only good outcomes are possible, and that they (or their managers) are competent to fashion portfolios that will expose them to all of the market's gains and few of its losses, to pick the winners and avoid the losers, and to ride the market's rise and get out just as it crests.
- And at the negative extreme, they conclude only bad outcomes are possible, and that any efforts to add value or cope with the market's vicissitudes on their part or the part of their now-defrocked managers will be utterly unavailing.

As we've seen endless times, investors reach the overconfident state when things have been going well for a while, meaning prices have already soared. And, alternatively, the latter hopeless state is inevitably reached after a bubble has been punctured, the news has turned unrelentingly negative, and prices have collapsed.

This is the pattern that makes the herd wrong at the extremes and creates the rewards for contrarianism. And it's behind my favorite Warren Buffett quote: "the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." **When most investors are driven to drop their prudence by an excess of confidence, we should be terrified. In the same way, when most investors become devoid of confidence and flee the market, we should turn aggressive.**

All Good or All Bad?

One of the things worth noting about the swing in confidence is not merely that it rises and falls, but that it is often marked by "all-good" or "all-bad" thinking. In short, when investors are optimistic regarding the future:

- They tend to see the positives, by which they're incredibly impressed, and overlook the negatives.
- If they consider negatives at all, they fall for rationalizations that refute them. Foremost here is the old standby: "It's different this time."
- Isolated positive developments, often random or fortuitous, are generalized into an irresistible virtuous circle. Coincidences are accepted as part of a bullet-proof cause-and-effect process.

This unobjective process eliminates balanced analysis and leads to dangerously unwarranted levels of confidence, and thus of investment risk.

The years leading up to the financial crisis of 2008 were marked by the most extreme all-good thinking I've ever seen. In fact, when *The New York Times* asked me to write an article on the cause of the crisis, the one I wrote was titled "Too Much Trust; Too Little Worry." I said an excessive level of confidence had caused investors in 2005-07 to:

- stop applying skepticism,
- stop worrying about losing money,
- stop doing thorough due diligence,
- stop factoring in conservative assumptions,
- stop applying risk aversion,
- stop denying capital to risky schemes, and
- stop demanding adequate risk premiums.

In mid-2007 I was working on a memo with the projected title "The Mother of All Cycles." But I got worried about how people would react to my borrowing a phrase from Saddam Hussein, so

when it was published on July 16, I changed the title to “It’s All Good.” In the memo I complained that every asset class, every asset and every region was appreciating.

In terms of amplitude, breadth and potential ramifications, I consider it the strongest, most heated upswing I’ve witnessed. A lot of this is because people seem to think everything’s good and likely to stay that way.

As I saw it, overconfident investors were ignoring the possibility of things going down as well as up, swallowing promises of limitless potential, suspending disbelief, accepting financial innovation as sure to work, and embracing the trend toward increased leverage.

Of course, this house of cards fell apart in short order. Thus that memo was followed by “It’s All Good . . . Really?” two weeks later, on July 30, and then by “Now It’s All Bad?” on September 10. In just eight weeks, confidence had evaporated and been replaced by widespread pessimism. And just a year after that, we witnessed the bankruptcy of Lehman Brothers and the onset of the worst financial crisis in 80 years.

What this reminds us is how dangerous the world can be when confidence is too high and people are too comfortable. Also, the speed with which things can reverse demonstrates, as my partner Sheldon Stone says, that the air goes out of the balloon much faster than it goes in. It usually takes years for confidence to reach a dangerous zenith, but then only weeks or months for it to collapse.



“Everything that was good for the market yesterday is no good for it today.”

When people conclude that all the merit is on either the positive or negative side of the argument, they reach extreme conviction regarding their view of the future and become certain they know

what to do. But all-good or all-bad attitudes are rarely right, since there are invariably valid points on both sides and they mustn't be ignored. Mark Twain said, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." **Most of the time, limits on confidence are more desirable than cocksureness. Over-confidence in one's judgment is very dangerous.**

The Bull/Bear Cycle

In March 2008, in "The Tide Goes Out," I repeated one of the most helpful of all the adages to which I hold – the description of the three stages of a bull market:

- the first stage, when a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone's sure things will get better forever.

What does it really mean? **The essential raw material for a bull market is cheapness, and that cheapness exists in stage one precisely because there are so few believers and so little confidence that favorable developments and good times lie ahead.** Thus stage one provides the launching pad for a bull market.

Equally, in the third stage the bull market is primed to end – with the bubble popping and a down-cycle setting in – for the simple reason that there are too many believers (and too few skeptics). **In short, there's too much confidence and too little cheapness. It's this imbalance that creates market tops.** The extremeness of the bull-market upswing – just like the downswing of its bear-market counterpart – gives investors what should be an important signal.

The Sure Thing

Investors may profess confidence in their ability to grapple with the future, but deep down many sense their own limitations and feel at sea. Thus they're prime targets for the newly minted "silver bullet" that's touted as sure to deliver return without commensurate risk. They develop outsized confidence in it, especially if at first it provides the hoped-for results. The most attractive of these are often mechanical, since their perfection stems from a dependable machine rather than a mysterious swami.

- In 1987, investors fell for "portfolio insurance," under which they could take on disproportionately large equity allocations, secure in the knowledge that if the market started down, the technique would automatically enter sell orders. But when the Dow Jones Industrial Average fell 22.6% on Black Monday (October 19), many brokerage firms refused to answer their phones, the sell orders weren't executed, and the "sure thing" turned out not to be.
- In the early 2000s, "portable alpha" promised high returns by overlaying hedge funds with equity futures. But when stocks fell, it became clear that the previous high returns

had come not from the value added by a dependable process, but from the fact that in essence the futures had allowed people to be more than 100% invested in a rising market.

- And more recently, “risk parity investing” worked through volatile times because it gave its followers greater strategic diversification, defensiveness and bond exposure than most other investors had. But it, like most other things, failed to prevent losses when Ben Bernanke spooked the market by threatening to ease off bond buying and let interest rates rise. This year’s results for risk parity show that nothing works all the time.

The point is that no mechanical tools can enable investors to prosper under all circumstances. They can provide tilts or reduce exposures, but the tool that promises a mix of good results and great results without the possibility of bad results is too good to be true. And when excessive confidence develops in such things, investors are heading for trouble.

The same is true for the Greenspan put and its successor, the Bernanke put. Alan Greenspan’s tenure as Fed chairman was marked by efforts to avoid problems by injecting liquidity and lowering interest rates. Investors put great stock in his ability to keep things moving ever upward. His policies prevented occasional corrections along the way, but the price paid was a big one: the financial crisis of 2008. Those who had believed in Greenspan’s omnipotence were unprepared for the consequences. Ben Bernanke succeeded Greenspan, and his own successor is likely to be announced soon. We must beware of equally excessive confidence in any individual’s abilities.

There is no magic solution. Nothing and no one can render economies, markets or portfolio results capable of rising but never falling. Awareness of that is wise. Belief to the contrary is dangerous.

* * *

As mentioned above, I think recently many investors have been holding riskier positions than are natural for them, largely because, thanks to the Fed’s low-rate policies, the lower-risk things they might have preferred offered so little return. Thus their investing actions were coerced, rather than being undergirded by confidence in the fundamentals.

The uncertainty that has been present in the last few years should have had a healthy effect on the environment by calling for a high level of prudence . . . if the Fed had let it take effect. But instead the Fed forced people into risk taking, and the combination of risk taking and weak resolve had the anticipatable effect when the first doubts reared their heads.

In May, Chairman Bernanke indicated that with the economy performing acceptably, the Fed’s bond buying might soon taper off, implying that higher interest rates were acceptable. This shouldn’t have come as a surprise, since when recovery occurs, a reduction of stimulus should be anticipated. The stock and bond markets’ subsequent dramatic swoons showed that the fundamental confidence underlying investors’ holdings of risk assets had been weak and

vulnerable, and that there had been too much reliance on the Fed keeping rates low. All of a sudden investors were less sure the world looked right, what the future held, and how to make money in it.

Investors remain uncertain, and that's good. Now that a bout of worry has been experienced, the credit markets are healthier (e.g., offering higher returns) than they were two months ago.

If the economy continues to recover and the Fed's bond buying eases off, interest rates are likely to go further on the upside. But given the modest level of confidence at play, the markets should not turn out to be perilous. Most assets are neither dangerously elevated (with the possible exception of long-term Treasury bonds and high grades) nor compellingly cheap. **It's easier to know what to do at the extremes than it is in the middle ground, where I believe we are today. As I wrote in my book, when there's nothing clever to do, the mistake lies in trying to be clever. Today it seems the best we can do is invest prudently in the coming months, avoiding aggressiveness and remembering to apply caution.**

* * *

A word about the long run: While conditions, confidence and asset prices all seem moderate today, meaning there's nothing brilliant to say about the short-term outlook, the long term remains worrisome. Because the U.S. is still able to attract capital from abroad and print money, our financial problems aren't pressing at the moment. But the combination of intractable deficit spending, unsustainable entitlement promises and a total dearth of responsible action in Washington certainly raises alarms regarding the future.

Since I see no reason to reinvent the wheel when someone I respect has said something better than I could, I'll close with a few words from Seth Klarman (emphasis added). Seth doesn't find much in the things he discusses to inspire confidence, and I agree:

There is no free lunch in economics: if governments could print or borrow money in astronomical amounts without any major adverse consequences, why wouldn't they always do this, forever avoiding downturns while their countries bask in the sunshine of limitless prosperity? Indeed it seems clear that prior misplaced confidence in the Fed contributed greatly to years of complacency that turned the 2008 downturn into a full-blown crisis. Of course there will be a price to pay for today's policy excesses – an equal and opposite reaction. We just haven't seen it yet. Will it take the form of a collapse of the dollar and the end of dollar hegemony, high interest rates, failed auctions of U.S. government securities and runaway inflation, a wrenching and protracted downturn requiring exceptional sacrifice, or something else? We will find out soon enough.

In most sectors of the economy – government, individual but also corporate – the U.S. has borrowed heavily to live beyond its means; we have been consuming through easy credit what we otherwise would have had to wait to buy. In the words of Michael Lewis, "Leverage buys you a glimpse of a prosperity you

haven't really earned." Asset values are contingent, as Jim Grant once said. But debt is forever. Instead of cutting back on leverage and getting our house in order, government response to the crisis has been to shift unaffordable debt from individual balance sheets onto the national ledger, where every day we owe more than ever before. . . .

I believe it is possible that the average citizen understands our country's fiscal situation better than many of our politicians or prominent economists. Most people seem to viscerally recognize that the absence of an immediate crisis does not mean we will not eventually face one. They are wary of believing promises by those who failed to predict previous crises in housing and in highly leveraged financial institutions. They regard with skepticism those who don't accept that we have a debt problem, or insist that inflation will remain under control. (Indeed, they know inflation is not well under control, for they know how far the purchasing power of a dollar has dropped when they go to the supermarket or service station.) They are pretty sure they are not getting reasonable value from the taxes they pay.

When an economist tells them that growing the nation's debt over the past 12 years from \$6 trillion to \$16 trillion is not a problem, and that doubling it again will still not be a problem, this simply does not compute. They know the trajectory we are on, and that the most successful country in the history of the world can go into decline if it becomes arrogant or complacent. When politicians claim that this tax increase or that spending cut will generate trillions over the next decade, they are properly skeptical over whether anyone can truly know what will happen next year, let alone a decade or more from now. They are wary of grand bargains that kick in years down the road, knowing that the failure to make hard decisions is how we got into today's mess. . . .

And when you tell the populace that we can all enjoy a free lunch of extremely low interest rates, massive Fed purchases of mounting treasury issuance, trillions of dollars of expansion in the Fed's balance sheet, and huge deficits far into the future, they are highly skeptical not because they know precisely what will happen, but because they are sure that no one else – even, or perhaps especially, the policymakers – does either.*

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