

Memo to: Oaktree Clients

From: Howard Marks

Re: On Uncertain Ground

The world seems more uncertain today than at any other time in my life. That's a simple sentence but one with significant implications. And it's not just me. Here's what *The New York Times* said on August 12 in an article about John Bogle, the founder of Vanguard:

"It's urgent that people wake up," he says. This is the worst time for investors that he has ever seen – and after 60 years in the business, that's saying a lot. . . . "The economy has clouds hovering over it," Mr. Bogle says. "And the financial system has been damaged. The risk of a black-swan event – of something unlikely but apocalyptic – is small, but it's real."

I'm going to devote this memo to the uncertainty in the world and the investment environment and then offer my take on the appropriate strategy response. This will require me to touch on a large number of topics, but I will try to dwell less than usual on each of them. If after reading this memo you find yourself hungry for more, you might go back to "What Worries Me" (August 28, 2008) and "The Long View" (January 9, 2009).

The Macro-Economic Setting

It's my belief that we're going to see relatively sluggish economic growth in the U.S. for a prolonged period of time. My expectations for other developed nations, given their specific issues, are even less positive. (This is a good time for my typical reminder that I am not an economist, and far from all of my observations would be supported by that fraternity. And please note that one of the key tenets of Oaktree's investment philosophy dictates that our investing will not be governed by macro forecasts. We say it's one thing to have an opinion on the macro, but something very different to act as if it's correct. I urge you to consider adopting a similar attitude toward all macro forecasts, especially mine.)

Around 2008 or '09, I had a visit from a senator looking – surprise! – for a campaign contribution. I suppose to make conversation, he asked if I could assure him we were headed for a vigorous recovery. "Forget vigorous," I told him. "I'm hoping for lackluster." I haven't changed my tune.

There's a very human tendency to think things will stay as they are, and if they change, that they'll revert to what we're used to. Most people think of economic growth as the norm; after all, that's been the general rule during our lifetimes. In fact, the global economy has grown nicely for hundreds of years. That's something "everyone knows." But how many people think about where economic growth comes from, and whether it's naturally occurring and inevitable?

Economic growth doesn't just happen. Its vigor depends on a combination of population gains, a conducive infrastructure, positive aspiration and profit motive, advances in technology and productivity, and benign exogenous developments. In many ways and to varying degrees, I think the future for these things in the U.S. is less good than it was in the past. The birthrate is down; our infrastructure is out of date; it's uncertain whether technology can add as much to productivity in the future as it has in the recent past (but perhaps it always is); and mobility up the income curve has stagnated.

I think a lot about the role of deficit spending and credit. In the forty or so years leading up to the crisis of 2008, consumers could grow their spending faster than their incomes because of the increasing availability of credit (and their increasing willingness to make use of it). Likewise, generous capital markets greatly facilitated deficit spending on the part of governments. Economic units around the world were able to spend money they didn't have and thus buy things they couldn't afford. This made a big contribution to economic growth, but few people recognized the negative implications: increased leverage, increased dependency on the continued generosity of the capital markets, and thus increased precariousness. In other words, unwise behavior in the short run led directly to problems in the long run. This is a normal aspect of the economic process.

Few debtors can tap the capital markets today to the same extent they could five or ten years ago. In a radical turn of events, lenders now appear to care about borrowers' ability to repay, and they find some of their customers less than creditworthy. Since almost no borrowers actually have the ability to pay off their debts, this has led to credit difficulties ranging from home foreclosures, to municipal bankruptcies in the U.S., to debt crises in peripheral Europe.

American consumers seem to have concluded that they should owe less (or have found that they can't borrow as much). For whatever reason, the savings rate has risen, suggesting a decline in the propensity to spend all one makes and more. All around the world, there's movement on the part of borrowers – sometimes voluntary and sometimes involuntary – toward austerity (reducing the excess of spending over incomes) or even delevering (spending less than you make and using the surplus to pay down debt).

These trends are healthy for individual borrowers' balance sheets, but they imply reduced consumption and thus are negative for GDP growth. If everyone does these things at the same time, the results can be quite contractionary. Regardless of how you look at it, less use of consumer credit implies less economic growth.

The other specific element that gives me pause relates to confidence. Psychology plays a huge role – perhaps a dominant and self-fulfilling one – in influencing economic growth. In short, if people think things will be good in the future, they'll spend and invest, and things will be good. But if they turn pessimistic regarding the future and go into their shells, refusing to spend and invest, growth will slow down.

Consumers were traumatized by the crisis of 2008: laid off, forced out of their houses, made poorer by market declines, and denied credit. Those who didn't feel these influences directly

were still pounded by headlines trumpeting economic weakness, the collapse of financial institutions, the need for bailouts, and malfeasance in the banking and mortgage industries. It could require significant healing before these influences abate.

Much of an economy's resilience comes from what economists call "animal spirits": the bullishness that drives things upward when people's innate optimism, acquisitiveness and tendency to forget harsh lessons are sparked by some bits of good economic news. Right now, with animal spirits largely in hibernation, a reversal of the crisis's trauma may not come easy. But that doesn't mean there won't be one. The U.S. consumer has a tendency to surprise on the upside.

Business investment plays a key role in economic recovery. When managers conclude that consumers are about to resume spending after a downturn, they hire workers and invest in new equipment in order to meet the increased demand they believe is coming. Yet the current recovery has seen little in this regard. I think the prevailing attitude has been, "Let's see how far we can stretch our current capacity before spending to expand it." Or as I heard on the radio the other day, in a report on productivity gains, "Businesses continue to do more with less." Thus companies have built cash hoards, not productive capacity.

Much of this has been attributed to uncertainty on the part of executives concerning the business environment. In contrast to the preceding 28 years of pro-business and pro-free market administrations under Presidents Reagan, Bush, Clinton and Bush, today many business people detect antipathy – or, at minimum, indifference – on the part of the Obama administration, in which the private sector is little represented. In addition, there is uncertainty and anxiety regarding the outlook for the economy, regulation and taxes. All of these things have deterred expansion.

Most recently, concern has shifted to the "fiscal cliff" – the combination of automatic tax increases and spending cuts that will go into effect at the beginning of 2013 if nothing is done before then by the seemingly gridlocked government (more on this later). Finally, most business people probably want Mitt Romney to be the next president, but he's behind in the polls. The sum of these doubts is contributing to the sluggish expansion we're seeing. (Of course, one of these days deferred spending could give way to invigorated investment in capacity.)

It's easy to view problems like these as insoluble and part of a self-feeding vicious circle. When people who are overly indebted reduce their spending, their collective action weakens the economy. The weak economy discourages businesses from hiring and expanding, and thus it stays weak. **It's essential, however, to remember that it can be just as wrong to see things as hopeless as it is to consider an environment risk-free.** One mustn't overreact in either direction.

Potential economic pluses do exist, and they tend to be overlooked in downcast periods like today. These include the incipient housing recovery; the possibility of energy self-sufficiency; the fact that U.S. manufacturing has slimmed down and our Chinese competitors have seen costs rise; and the fact that the U.S. still leads in higher education, creativity and entrepreneurship.

For me, the bottom line of all this is that we aren't looking at a period of prosperity. A recovery is underway and is likely to continue, but it is more likely to be lackluster than vigorous. Most Americans' financial memory consists of V-shaped recoveries and periods of good feeling like the 1990s, when they couldn't think of reasons not to borrow and spend. Five years from now, I think people will still be asking, "When will the economy get going? When will we get back to good times?"

Black Swans, Landmines and Long-Term Problems

In addition to this unexciting general outlook, I (like most others) can reel off a litany of current and potential problems like I've never seen before. Each one deserves a memo, but – as I said – I'm trying to be economical with your time and attention.

- **Europe** represents a problem of enormous proportions, huge risk and limitless uncertainty. The nations and banks of Europe – and especially Portugal, Italy, Ireland, Greece and Spain (the PIIGS) – partook liberally of the excessive ability to borrow described above. They squandered the proceeds in a variety of ways, ranging from excessive benefit programs for citizens to ill-fated investments. They owe amounts they can't ever repay and will have trouble servicing in times of economic weakness. They'll be forced to spend less in the period ahead, but that will further weaken their economies and add to the pain felt by their citizens. The results have included unrest and may continue to do so. And yet – despite attempts at austerity and delevering – in many countries the ratio of total public and private debt to GDP is now greater than it was five years ago (according to Jamil Baz of GLG Partners).

People ask all the time what will happen in Europe. I tell them the situation is enormously complex, murky and uncertain, but I'm absolutely sure of three things: (a) I don't know, (b) nobody knows, and (c) if you ask an expert for advice and follow it, you'll probably be making a mistake.

When people invest in an Oaktree fund, it's on the basis of a limited partnership agreement that spends a few pages on what we're going to do and dozens more on things like the rules we'll follow and what happens if we don't. I get the impression that in the case of the European Union, politicians wrote the first section based on glowing hopes but forgot about the rest. When faced with conditions like these, in my view, there's absolutely no alternative to saying we have no idea what the future holds. Period.

Since the nuts and bolts stuff was omitted, there's no schematic diagram or instruction manual for Europe. There are no procedures for ensuring nations don't run excessive deficits, or for moving a member state out of the European Union. Any actions that are taken will require unanimous decisions on the part of elected officials from nations with divergent interests. Taking all of this together, I feel there can be no certainty about:

- what should be done to fix the problem,
- what can be done,

- what will be done, and
- what the ramifications will be, especially the second-order consequences.

I imagine Europe's leaders will muddle through, continuing to do the absolute minimum that suffices at the last possible moment. There will be palliatives, but solutions will be hard to achieve (the latter would require the nations of Europe to significantly surrender sovereignty). Last week the European Central Bank announced a program of bond buying, and this was viewed positively. Buying bonds will keep borrowing costs down for as long as it's practiced, but it won't solve the problems. The important tasks facing the peripheral nations are much greater: cutting deficits and policing them, reducing the excessive debt burden that was allowed to build up, and restoring growth and competitiveness. Thus the problem is likely to drag on for years, assuming it doesn't flare up into a global crisis. Everyone hopes Europe will do what's needed, but hope isn't much of a plan.

- **The U.S. fiscal situation** is less acute, less immediate, and easier to duck given that we can print the world's reserve currency . . . but little better. In fact, in some ways it is more dangerous because the problems are more back-end loaded and perhaps less overt.

Our politicians, too, used easy money to give everyone everything: generous benefit programs as well as significant tax reductions (and major stimulus programs when needed). Entitlements, interest and other mandatory expenditures consume all of the taxes collected; forget about the rest of government spending – on things like defense, education, transportation and scientific research. We face huge annual deficits and ballooning national debt.

As an aside, one reason our deficit situation isn't worse today is the ultra-low level of interest rates, which constitute a tremendous subsidy of the government by savers. Even with these low rates, interest on the federal debt consumes roughly 10% of all federal taxes collected. Imagine what the deficit would be if the 10-year Treasury note were at 7% rather than less than 2%.

Entitlement programs are the biggest problem, primarily Medicare (healthcare for the elderly), Medicaid (healthcare for the poor) and Social Security (retirement benefits). Politicians in years gone by granted benefits without much thought to the rate at which they would grow and where the money to pay them would come from. Benefits have been expanded or indexed to inflation, and the post-war Baby Boomers, with their much-increased life expectancies, are bound to create an incredible burden; the national debt of \$16 trillion is dwarfed by unfunded future benefits, the present value of which is variously estimated at an additional \$50-90 trillion.

We have problems at the state and local level, in addition to the federal. The federal government is pushing burdens off to states and reducing funding; at the same time the soft economy is cutting into state and local tax collections and increasing citizens' needs. I recently read about a city that had to choose between policemen, firemen and teachers for the layoffs through which to balance its budget. In other words, the city has been

providing a level of services that it can't afford. Painful austerity is unavoidable; neither firemen, policemen nor teachers can be easily dispensed with. Also, for years state and local politicians have promised public employees retirement and health benefits without regard for how they would be paid. Pension plans that are currently underfunded by \$1-3 trillion represent a ticking time bomb. We've seen a spate of municipal bankruptcies this year, and I believe more are coming.

- **The depressing state of politics** deserves special mention among the problems we face. Having acted in the past to create unfunded, ballooning benefit burdens, politicians – albeit a new crop – now largely refuse to agree on action to reduce them. And no one seems to be penalized for failing to find a solution.

Just as the need for unanimity will frustrate Europe's attempts to solve its problems, U.S. politicians seem to value things like "ideological purity" (i.e., toeing the party line) and being reelected above real attempts at problem solving. They say they want to solve the deficit problem, but tax increases are off limits for many; cuts in entitlements are anathema for others; there isn't enough discretionary spending left to cut in order to solve the problem; and "compromise" has become a dirty word.

In 2010 a group of active and retired politicians – the Simpson-Bowles Commission – was asked to come up with a solution. Eleven of the eighteen members supported a responsible proposal including, of course, some pain, but there wasn't the fourteen-vote supermajority needed to formally endorse it. Congress and the White House let it die of inattention. Despite the enormous danger presented by our current and future deficits, too few were willing to touch matters representing the "third rail" of American politics.

Of course, it's not just the politicians. Many voters say they prefer elected officials who will refuse to "desert their principles" (that is, compromise with the other side in pursuit of a solution). While some voters may understand the risk presented by entitlement programs, most reject any reduction of their own benefits.

Paul Ryan, the Republican nominee for vice president, is a "fiscal wonk" who cares about the deficit and has a "Ryan Roadmap" to shrink it. Here's what he says on the subject:

© Washington has not been telling you the truth. If we don't reform spending on government health and retirement programs, we have zero hope of getting our spending – and as a result our debt crisis – under control. (*The New York Times*, August 12, 2012)

Ryan was chosen for the ticket because his hawkishness on the deficit and overall conservatism were expected to appeal to the Republican "base." But ironically, Ryan's interest in reforming entitlements may constitute a disadvantage on the campaign trail, requiring some serious backtracking. Too many people simply vote their wallets: self-interest usually trumps ideology. While we can disagree with Ryan's approach, we should applaud the rare politician who is willing to tackle this unpopular subject.

- Given the way “inflation hawks” on the Federal Reserve Board resist stimulating the economy when a recovery is underway, there’s **concern over the ability to count on further stimulus**. However, I expect the Fed to keep interest rates low for a prolonged period of time and/or undertake other stimulus actions. Recent statements from Chairman Bernanke leave little doubt on this subject. On the other hand, just as I think a lot of economics is determined by psychology, so do I believe a lot of the impact of stimulus programs is psychological. Interest rate cuts, and bond buying programs like QE, have shock value when first announced, but I think it diminishes over time. In the end, it’s not easy to make an economy grow when people aren’t thinking expansively.
- Today’s low interest rates, engineered by the central banks, mean that investors are consigned to doing business in a **low-return world**. Interest rates near zero on T-bills, and yields of 1-3% on Treasury notes and bonds, set the base from which the prospective returns on investments entailing risk are established. And because that floor is so low today, even with healthy risk premiums added, the absolute prospective return on many investments isn’t nearly what it was in the past.
- The long-term competitive position of the U.S. is threatened by our **deteriorating infrastructure** in areas like education, healthcare and transportation (as well as trends that are enabling other nations to catch up to us in these regards). These are things that made America great following World War II, but there seems to be little will (or money) to restore them to previous levels.
- In my view, **growing income inequality** is a significant problem. The difference in incomes between those at the top and those at the bottom has risen dramatically, and the ability of those at the bottom to move up the chain has declined. Tax rates applied to income on capital (capital gains and dividends) have been cut relative to those on labor. Finally, everyone knows more than ever about how well the people at the top are doing. A lot of America’s economic success has stemmed from the fact that people in the lower income brackets felt the system would allow them to move up through hard work. To the extent that becomes less true – and the outlook today is guarded, especially given the low quality of public education – there can be negative ramifications for society overall.
- **The world of today seems full of intractable challenges**. Think about the list of actual and potential problem areas: Iraq, Afghanistan, Iran, Israel/Palestine, Syria, Pakistan, North Korea, and occasional flare-ups in former Soviet republics. In contrast, the period from the fall of the Berlin Wall (1989) and the USSR (1991) up until the attacks on September 11, 2001 seems like a halcyon one largely free of conflicts considered capable of destabilizing the world. The comparison is stark and troubling.
- The last big element of uncertainty on my list is the **outlook for China**. In the years leading up to today, what characterized China?
 - underused resources, largely human, and low manufacturing costs,
 - an economy directed centrally, not by free market forces,
 - rapidly growing financial resources,

- a strong desire for economic growth and industrialization in order to move the population to the cities and upward in economic terms,
- the need to respond to the global financial crisis of 2008 and the non-performing loans it produced,
- an expectation that manufacturing would expand without limit as China supplied goods to nations around the world as well as its own growing consumer class, and
- resulting certainty that China couldn't miss.

The upshot of all of the above was massive provision of capital in order to advance China's economic development and urbanization. State-owned enterprises were created and expanded, and infrastructure building was accelerated. Residential construction, in particular, took place at an elevated rate.

This may have been yet another instance where too much money led to bad capital allocation decisions. China's modern era had seen only growth, not cycles of boom and bust. Even when the central government wanted to rein in the rate of building, local governments – which derive a lot of their revenue from sales of land for development – were not similarly motivated. Chinese individuals faced very limited options for investing their capital: bank interest was below the rate of inflation and thus negative in real terms, and foreign investment was prohibited. This combination drove large-scale investment into either properties or savings products known as “trusts,” the proceeds of which flowed into fixed asset development. Thus the process went out of control. Good intentions around urbanization and infrastructure development fell victim to massive speculative capital flows. The consequence was excessive fixed investment.

(One great way for authorities or central bankers to stimulate an economy is by providing capital for residential construction. This results in increased employment and spending on materials and components. When the economy heats up in response, however, a housing bubble often ensues. Home prices rise and speculative buying follows. The only thing missing is end-buyers for the unneeded or unaffordable homes. It's particularly interesting to note that excess residential investment contributed in a major way to the recent problems in China, Ireland, Spain and the U.S. In all four countries “Potemkin villages” of new homes grew up, suggesting economic vigor . . . but standing empty.)

In China's case, capital wasn't withdrawn by external lenders. Rather, the central planners decided it was time to reduce stimulus. In this way leverage would be reduced, the rate of fixed asset investment would ease, and the economy would be kept from overheating and inflating. However, as has been seen throughout history, planned economies tend to defy the planners, and cycles are hard to modulate.

China's economic growth has slowed, and living with declining growth has turned out to be no easier in China than elsewhere. Worldwide economic weakness and cost-advantage-eroding inflation have reduced the demand for Chinese exports, a main prop supporting China's economy. It has been made clear that (a) internal consumption isn't enough to give China's economy the growth it needs and thus (b) China isn't without

dependence on the rest of the world. **It has yet to be determined whether China's landing will be soft or hard.**

And if China lands hard – in part because of weak demand from the rest of the world – will its weakness feed back, further weakening those nations from which China buys raw materials and finished goods? The world's economy is complex, interrelated and interdependent. China is a major example of this and, at this moment, a contributor to worldwide uncertainty.

So what do we find? Economic fragility throughout the world, I think, as well as a number of factors capable of exacerbating the situation in the short run or keeping it weak in the long. I can't remember a time when no jurisdiction was considered completely safe for investment, but that seems to be the case today. When people enthuse about the U.S., it's usually only in relative terms: "the best house on a bad block."

At the University of Chicago in the 1960s, I was taught that U.S. Treasury bills paid the "risk-free rate of return." Nowadays most investors have trouble thinking of anything as riskless. When I talk to investors, most of them snicker uncomfortably about the proposition of even U.S. Treasuries being entirely safe.

Is There No Good News?

Isn't there anything on the positive side of the ledger, capable of balancing against the weak fundamental picture described above and making investment attractive? A few things deserve mention, I think.

The first is **the possibility that things won't turn out to be as bad as I describe.** Because of the impact of psychology on people's thought processes, it often turns out that things aren't as bad (or as good) as they seemed at the extremes. But since I'm not a big believer in macro forecasting, I don't believe there's a way to prove that my negativism isn't fully warranted.

The second is **the fact that asset prices are reasonable in many cases, at least relative to other investments or to history.**

- In 1999, when everyone was unworried, the S&P 500 traded at more than 30 times earnings. Today the p/e ratio has more than halved, and it is well below the post-World War II average. In addition, dividend and earnings yields on equities are unusually favorable relative to the yields on bonds. There's no doubt that stocks have cheapened relative to historic parameters – although the case can also be made that they aren't cheap enough, since future growth is unlikely to be at the historic rate.
- Yield spreads on high yield bonds relative to Treasuries are at levels that historically have been considered generous and have consistently given rise to subsequent returns well above those on Treasuries. In other words, the reward for accepting credit risk via high yield bonds is at a level that in the past has more than compensated for the credit risk

entailed. Although there's far less historic data, the same seems true of senior loans and mezzanine debt.

- Real estate prices have corrected from the peak of 5-6 years ago and are largely back to the pre-bubble levels of a decade ago. Residential real estate prices are well down from the peak, and the same is true for commercial real estate in all but a half dozen first-tier cities.

And why is this true? Because of the third factor: **investor psychology that is much curtailed from pre-crisis levels**. This is very healthy from a buyer's point of view.

The Psychological Environment

These are uncertain times – there's no doubt about it. The macro outlook is quite unclear, and the level of investor confidence is commensurately low. This reminds me of something that happened – in the larger, non-investment world – eleven years ago this week.

I was in New York on 9/11, and I experienced the uncertainty, fear and confusion firsthand. When I finally got to California several days later, I sat down with my son Andrew, then fourteen years old, to make sure he was okay given what had transpired. He asked me, with his usual perceptiveness, "Dad, is the world less safe than it used to be?" The right answer came to me: "Maybe it's less safe than it used to be . . . and maybe it was never as safe as people thought it was." **Similarly, the macro future seems far more uncertain today than at any time in my experience, but there's a good chance it was never as certain as people thought.**

In the 1980s and '90s, everything went right. Economic growth was strong. Companies thrived. There were great gains in productivity and technology. Profits rose dramatically. Interest rates declined. Inflation was quiescent. Equities soared. Houses and 401k accounts appreciated, producing a positive "wealth effect." The world was largely at peace. All of this contributed to positive psychology, feeding back to further spur economic strength in a classic virtuous circle. Was this a period in which favorable outcomes were entirely dependable, or just one in which the underlying processes met up with good luck, producing favorable outcomes? And if the latter, were the results better than people should have expected to continue?

Regardless, people did extrapolate them. When stocks returned 20% a year in the 1990s, rather than the normal 10%, investors ratcheted up their return expectations for the subsequent years, and with them their allocations to equities. **Everyone knows that if you reach into a bag containing both black and white balls and pull out ten white ones in a row, the probability has increased that the next one will be black. But in the investment world, events like that serve to convince people that there are only white balls – favorable outcomes – in the bag. That's part of the illogical, emotional thinking that makes for bull markets and bubbles.** So by the time the late 1990s rolled around, many investors had concluded that the world was a benign place in which profits were inevitable. That is, that there was little risk or uncertainty.

It's my firm belief that the riskiest thing in the investing world is widespread belief that there's no risk. Usually that dangerous condition stems from excessive conviction that the future is knowable and known . . . and benign. Today there's very little of that. I think that's a substantial positive.

It was one of the outstanding characteristics of the pre-crisis period of 2005-07 that most people were sure they completely understood (a) what made the economy work, (b) what the world would look like in five or ten years, and (c) how things could be fixed if problems arose. Today very few people feel that way. There's nothing pleasant about the transition from feeling you know something to realizing you don't.

But the risk in an activity doesn't stem just from the activity itself, but from how people approach it. When equipment is developed that makes mountain climbing safer, people change their behavior in ways that make it more risky. Equally, much of the risk in investing stems not from securities, companies or exchanges, but from investor behavior. **In short, risk is low when investors behave prudently and high when they don't.**

A world that's perceived as safe can be rendered unsafe if the perception of safety causes investors to move out the risk curve, bid up prices, or take actions that assume greater certainty than turns out to be the case. I think that perfectly describes the years leading up to the crisis. **Conversely, an uncertain world can be safer than people perceive if their concern causes them to behave cautiously (and especially if it causes them to sell down assets to prices from which the likelihood of further declines is reduced).** Certainly few people in the world today are oblivious to the litany of outstanding negatives.

Please note, however, that while investor ardor and risk-blindness are at reassuringly low levels today – and that may be the best single thing that can be said for the current environment – the actions of central banks to minimize interest rates have served to force investors out on the risk curve in search of return. They may not be blind to the risks, but many are participating in pro-risk activities nevertheless. I refer to these coerced participants with a phrase from my late father-in-law, Sam Freeman: “handcuff volunteers.”

The Role of Macro

These days we hear little about anything other than macro considerations. Security movements are highly correlated, meaning investment returns are more a function of broad market movements than individual security characteristics. And market movements are, in turn, primarily in response to macro developments.

Thus investors believe more than ever that the route to investment success lies in correct judgments about the macro future. This has given rise to so-called “risk-on, risk-off” investing, consisting of investors' attempts to profit by increasing their risk exposure when they expect favorable macro developments, and decreasing it when they foresee unfavorable developments. Since macro events determine most of the results, it's on the macro that investors believe they should spend their time.

I couldn't agree less. Playing the market in the short term based on macro forecasts is one of the many things in investing that could add greatly to results if it could be done right . . . but it can't, certainly not consistently.

The expected value from any activity is the product of the gains available from doing it right multiplied by the probability of doing it right, minus the potential cost of failing in the attempt multiplied by the probability of failing. Investors are often blinded by the potential gains from a tactic and thus don't think much about the likelihood they can get it right. Because I think so little of the ability to make correct forecasts – and especially of the ability to get the timing right – I dismiss attempts to benefit from short-term macro judgments.

The best response when seas are choppy is to focus on completing the long-term voyage and not think about whether the next wave is going to push the nose of the boat up or down.

Our investment destination is best reached by accurately valuing assets, assessing the relationship between price and that value, and acting resolutely and unemotionally when mispricings are detected. That's still the best – I think the only – reliable path to investment success. Nothing about the current environment alters that one bit.

Some Thoughts on Strategy

While I don't believe in short-term tactical adjustments based on macro expectations, I do think clients, portfolio managers and strategists should take macro conditions into account when positioning portfolios for the medium term. And while I'm a big skeptic regarding forecasting, I think we can't ignore the long-term secular outlook. (Is that an inconsistency? Absolutely!)

On January 10 of this year, I sent out a "clients-only" memo called "What Can We Do For You?" It has since been posted to the website, and I hope you'll take a look at it. I said in that memo that I had come up with three questions that might help in setting strategy.

- Do you expect prosperity or not? A simple, not-necessarily-precise judgment on this subject can strongly influence our choice of investment media and approach. As described at length above, it's my conclusion that we won't soon see a return to the prosperity of the pre-crisis years.
- Of the two main risks in investing, which should you worry about more today: the risk of losing money or the risk of missing opportunities? Certainly today's macro uncertainties argue for worrying about loss. But even as the low-return climate suggests we needn't give much thought to opportunity costs, the near-zero returns offered on the safest investments (and the moderate level of asset prices) argue for assuming some risk in the pursuit of a more satisfactory return.
- What kind of investing attributes should you employ today, aggressive or cautious? As above, I feel the pros and cons are balanced, and thus so should be our behavior.

On one hand, we face a lackluster general economic outlook and the threat of further negative developments that could be impactful but hopefully are not overwhelmingly likely. On the other, these worries may be offset to a degree by the lowness of asset prices and investor psychology. The former elements argue strongly against aggressive investing, but the latter – and the low promised returns on highly safe investments – argue that one’s investment program should include some forward movement.

When I attended the University of Chicago it was very fashionable to use the qualifier *ceteris paribus*: “all other things being equal.” So I can flatly state that, *ceteris paribus*, an outlook characterized by slow growth, potential serious problems and great uncertainty should call for (a) more fixed income investments than equities, (b) more pursuit of value today than growth tomorrow and (c) more safe investments and less use of leverage.

However – and it’s the biggest possible “however” – all else is far from equal today. Safe investments have been bid up, such that the returns available on them are paltry at best. If you buy the ten-year U.S. Treasury note today at 1.7%, it’s hard to imagine environments other than depression and deflation in which you’ll be happy with the outcome. So one of the more important conclusions is that this isn’t a black-and-white world in which it’s reasonable to insist on safety and eschew risk. **Unless you consider loss avoidance overwhelmingly important and can truly forgo making money, the approach for today has to balance risk aversion and the pursuit of return.**

Moderate investment expectations are an important element in setting one’s course. Anyone who insists on returns like “the good old days” is heading for trouble. A somewhat reliable return in the high single digits or low double digits to mid-teens would represent an outstanding result today. I would counsel against trying for much more – or at least that any attempt to do so should be recognized as entailing some very real risk.

What should one do when faced with the conditions confronting us today? I think the smartest response still consists of investing in well-priced corporate securities and income-producing assets. Corporations still have the best chance of adjusting to environmental phenomena such as inflation, dislocation and competition.

An obscure 1958 book, *Corporate Bond Quality and Investor Experience* by W. Braddock Hickman, is said to have given Michael Milken a lot of his inspiration to popularize high yield bonds and foster new issue and secondary markets for them in the 1970s. In his book, Hickman reports on the performance of corporate bonds between 1900 and 1943. He shows that the lower a bond’s quality and rating, the higher the return from holding it.

This is a very important conclusion. Aside from arguing for high yield bond investing, it shows that even in this period, which included the Great Depression, corporate bond investing was quite successful. What that tells me is that despite the extremely tough economic climate, many corporations were able to make money and service their debt. This supports my belief that corporate investing represents an attractive strategy for uncertain times.

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The simplistic view says that because the world is uncertain today, we shouldn't venture forth. But I think it's much wiser to say that despite the uncertainty, we shouldn't automatically settle for assets believed to be entirely safe – especially since (a) flight of capital to their seeming safety has rendered their promised returns low and (b) that safety can prove to be illusory. Instead we should attempt to take control of our fate and strive for reasonable returns with the risks handled responsibly.

And one of the most interesting aspects of investing stems from the fact that you can't just do nothing. **In the investing world, even doing nothing is doing something.** It's choosing to stay with what you have rather than switch to what you could have. It's deciding to deal with the environment passively rather than actively. And it's avoiding the risky to stay with the seemingly safe. These are significant actions, and they must be undertaken on the basis of serious analysis and active decision making.

The challenge today is that while you can get less-than-safe things relatively cheap because the crowd is desperate for safety, the crowd's concerns are not imaginary. If you turn up the risk because you think the premium being paid for safety is too high, there are scenarios under which you will have made a big mistake. Because the probability of those scenarios occurring is materially above zero, we can't dispense entirely with caution.

The presence of arguments on both sides renders strategy setting difficult today. But when all the arguments are on the same side, making the choice clear, that clarity can lead the investing herd to create a bubble or a crash. Thus our criterion for moving ahead can't be that the way forward has to be obvious. I'm going to repeat what Charlie Munger told me about investing a couple of years ago, even though I used it in my last memo, too: "It's not supposed to be easy. Anyone who finds it easy is stupid."

The outlook certainly isn't so propitious (and assets aren't so cheap) as to call for investing aggressively. But at the same time, market conditions tell me this isn't a time for hiding under the bed. "Move forward, but with caution" -- that's my mantra today. The environment is uncertain, but we shouldn't find that paralyzing.

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