

Addendum to Third Quarter Client Letter

From: Howard S. Marks

Re: The Route to Performance

We all seek investment performance which is above average, but how to achieve it remains a major question. My views on the subject have come increasingly into focus as the years have gone by, and two events in late September -- and especially their juxtaposition -- made it even clearer how (and how not) to best pursue those superior results.

First, there was an article in the Wall Street Journal about a prominent money management firm's lagging performance. Its equity results were 1,840 basis points behind the S&P 500 for the twelve months through August, and as a result its five-year performance had fallen behind the S&P as well. The president of the firm explained that its bold over- and under-weightings weren't wrong, just too early. Here is his explanation, with which I strongly disagree:

If you want to be in the top 5% of money managers,
you have to be willing to be in the bottom 5%, too.

The above calls to mind a convertible mutual fund I discussed in my second quarter 1988 letter to convertible clients. The fund held large amounts of common stock in the first eight months of 1987 and cash after that. As a result, its return was more than 1,600 basis points better than the average convertible fund for the year, and 945 b.p. ahead of the second-place fund. In the next half year, its tactics were equally divergent ... but wrong this time, producing performance which was far enough behind to negate the majority of its 1987 achievement and pull its 18-month results well back into the pack. My observation at that time mirrored the fund manager quoted above, but from a negative viewpoint:

... in order to strive for performance which
is far different from the norm and better, you
must do things which expose you to the possibility
of being far different from the norm and worse.

These cases illustrate that bold steps taken in pursuit of great performance can just as easily be wrong as right. Even worse, a combination of far above-average and far below-average years can lead to a long-term record which is characterized by volatility and mediocrity.

As an alternative, I would like to cite the approach of a major mid-West pension plan whose director I spoke with last month. The return on the plan's equities over the last

fourteen years, under the direction of this man and his predecessors, has been way ahead of the S&P 500. He shared with me what he considered the key:

We have never had a year below the 47th percentile over that period or, until 1990, above the 27th percentile. As a result, we are in the fourth percentile for the fourteen year period as a whole.

I feel strongly that attempting to achieve a superior long term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year -- and through discipline to have highly superior relative results in bad times -- is:

- less likely to produce extreme volatility,
- less likely to produce huge losses which can't be recouped and, most importantly,
- more likely to work (given the fact that all of us are only human).

Simply put, what the pension fund's record tells me is that, in equities, if you can avoid losers (and losing years), the winners will take care of themselves. I believe most strongly that this holds true in my group's opportunistic niches as well -- that the best foundation for above-average long term performance is an absence of disasters. It is for this reason that a quest for consistency and protection, not single-year greatness, is a common thread underlying all of our investment products:

In convertibles, we insist that our call on potential appreciation be accompanied by above average resistance to declines.

In high yield bonds, we strive to raise our relative performance by avoiding credit losses, not by reaching for higher (but more uncertain) yields.

In distressed company debt, we buy only where we believe our cost price is fully covered by asset values.

There will always be cases and years in which, when all goes right, those who take on more risk will do better than we do. In the long run, however, I feel strongly that seeking relative performance which is just a little bit above average on a consistent basis -- with protection against poor absolute results in tough times -- will prove more effective than "swinging for the fences."

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