Memo to: Oaktree Clients

From: Howard Marks

Re: The Happy Medium

My second general memo to clients was dated April 11, 1991 and imaginatively titled "First Quarter Performance." It primarily discussed the swing of the market pendulum. I may be biased, but I'm pleased with what it says and, thirteen years later, wouldn't change a word.

> The mood swings of the securities markets resemble the movement of a pendulum. Although the midpoint of its arc best describes the location of the pendulum "on average," it actually spends very little of its time there. Instead, it is almost always swinging toward or away from the extremes of its arc. But whenever the pendulum is near either extreme, it is inevitable that it will move back toward the midpoint sooner or later. In fact, it is the movement toward the extreme itself that supplies the energy for the swing back.
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> Investment markets make the same pendulum-like swing:
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> - between euphoria and depression,
> - between celebrating positive developments and obsessing over negatives, and thus
> - between overpriced and underpriced.
>
> This oscillation is one of the most dependable features of the investment world, and **investor psychology seems to spend much more time at the extremes than it does at the "happy medium."** (Emphasis added)

Although I've learned a great deal in the time since that memo was published, I still think the paragraphs excerpted above capture almost the entire essence of market movements.

I continue to believe that cycles are inevitable, often profound, and the most reliable feature of the business and investment worlds. In November 2001 I wrote a memo on this subject entitled "You Can't Predict. You Can Prepare." (It didn't generate any reader reaction, even though I thought its contents were important.) The memo discussed some of the cycles that affect the investor:

- The **economic cycle** evidences **moderate fluctuations** (although their impact can be profound). Viewed on a long-term graph, it looks like a gentle wave.

- The **business cycle** responds to developments in the economy with a **more pronounced effect**, rising and falling as consumers and businesses loosen and tighten their purse strings.

- The **profits cycle** reflects an **exaggerated reaction** to changes in the amount of business companies are doing, primarily because of the twin influences of operating leverage (such that operating profits change more than revenues) and financial leverage (such that net income changes more than operating profits).

- The **credit cycle** moves **dramatically**, usually oscillating between periods when the capital markets are wide open and periods when they're slammed shut.

- The **market cycle** reacts **violently**, as investor psychology magnifies all of the above. Security prices yo-yo in what can often be described as extreme over-reaction.

Everyone's aware of these cycles and their influence on the markets, but it's important that their essence and origin be thoroughly understood. For me that means delving into human nature and emotion. The theme of this memo will be that **the cyclical phenomena that so heavily influence our investment outcomes aren't caused by the operation of institutions or physical laws. Rather, they largely result from people's frailties and excesses**. A thorough understanding of these things can increase an investor's ability to achieve gains and avoid losses.

<u>Greed or Fear</u>

When I was a rookie analyst, we heard all the time that "the stock market is driven by greed and fear." When the market environment is in healthy balance, a tug-of-war takes place between optimists intent on making money and pessimists seeking to avoid losses. The former want to buy stocks, even if they have to pay a price a bit above yesterday's close, and the latter want to sell them, even if it's on a downtick.

When the market doesn't go anyplace, it's because the sentiment behind this tug-of-war is evenly divided, and the people – or feelings – on the two ends of the rope carry roughly equal weight. The optimists may prevail for a while, but as securities are bid up they become more highly priced, and then the pessimists gain sway and sell them down. The result is a market that rises or falls moderately if at all – not unlike the experience so far this year. For example, as The Wall Street Journal wrote on May 17,

> The Dow Jones Industrial Average has been down for three weeks in a row, . . . Still, a determined group of optimists has refused to throw in the towel, stepping in to buy what they view as cheap stocks whenever prices began to plummet. On Wednesday, when the Dow Industrials fell as low as 9852.19 during the day, these people began to buy, pushing the blue-chip average back above 10000.
>
> Two forces continue to compete in the market: those who believe that the current skittishness will end once investors get used to the idea of rising interest rates, and those who think further stock declines are inevitable.

It didn't take long in my early days, however, for me to realize that often the market is driven by **greed <u>or</u> fear.** At the times that really count, large numbers of people leave one end of the rope for the other. Either the greedy or the fearful predominate, and they move the market dramatically. **When there's only greed and no fear, for example, everyone wants to buy, no one wants to sell, and few people can think of reasons why prices shouldn't rise.** And so they do – often in leaps and bounds and with no apparent governor.

Clearly that's what happened to tech stocks in 1999. Greed was the dominant characteristic of that market. Those who weren't participating were forced to watch everyone else get rich. "Prudent investors" were rewarded with a feeling of stupidity. The buyers moving that market felt no fear. "There's a new paradigm," was the battle cry, "get on board before you miss the boat. And by the way, the price I'm buying at can't be excessive, because the market's always efficient." Everyone perceived a virtuous cycle in favor of tech stocks to which there could be no end.

But eventually, something changes. Either a stumbling block materializes, or a prominent company reports a problem, or an exogenous factor intrudes. Prices can even fall under their own weight or based on a downturn in psychology with no obvious cause. Certainly no one I know can say exactly what it was that burst the tech stock bubble in 2000. But somehow the greed evaporated and fear took over. "Buy before you miss out" was replaced by "Sell before it goes to zero."

And thus fear comes into the ascendancy. People don't worry about missing opportunities; they worry about losing money. Irrational exuberance is replaced by excessive caution. Whereas in 1999 pie-in-the-sky forecasts for a decade out were embraced warmly, in 2002 investors chastened by the corporate scandals said, "I'll never trust management again" and "How can I be sure any financial statements are accurate?" Thus almost no one wanted to buy the bonds of the scandal-plagued companies, for example, and they sunk to giveaway prices. **It's from the extremes of the cycle of fear and greed that arise the greatest investment profits, as distressed debt demonstrated last year.**

Risk Tolerance or Risk Aversion

In my opinion, the greed/fear cycle is caused by changing attitudes toward risk. **When greed is prevalent, it means investors feel a high level of comfort with risk and the idea of bearing it in the interest of profit. Conversely, widespread fear indicates a high level of aversion to risk**. The academics consider investors' attitude toward risk a constant, but certainly it fluctuates greatly.

Finance theory is heavily dependent on the assumption that investors are risk-averse. That is, they "disprefer" risk and must be induced – bribed – to bear it. That's the reason why the capital market line slopes upward to the right: investors have to be offered higher expected returns in order to induce them to make investments entailing higher risk. Of course, these higher returns can't be a sure thing, because in that case the investments wouldn't actually be riskier. So the higher expected returns have to be accompanied by greater uncertainty (a broader dispersion of possible outcomes) or higher actual risk of losing money.

But there are times when investors ignore the uncertainty and risk of loss associated with higher possible returns and pursue them too avidly. In 1996, I asked a consultant why his firm was one of the few that didn't recommend Oaktree's high yield bond management. His answer was simple: "We're trying to maximize risk, and we can't do that with you." Of course, that answer was shorthand for something that made a little more sense: that in theory the way to increase return is to bear more risk, and he thought Oaktree's portfolios didn't contain enough risk to be top performers. **In other words, he was saying, "risk is our friend."**

It just can't work that way! **Dependably high returns from risky investments are an oxymoron. But there are times when this caveat is ignored; when people get too comfortable with risk; and thus when securities prices incorporate a premium for bearing risk that is inadequate to compensate for the risk that's present.**

The prevalence of risk-tolerance (or risk-obliviousness) in the late 1990s was clear. I personally heard a prominent brokerage house strategist say, "Stocks are overpriced, but not enough to keep them from being a buy." And we all heard the man on the street say "I'm up so much in my 401(k), it wouldn't bother me if it fell by a third." (Where was that guy two or three years later?)

No, those risk-tolerant attitudes will not persist forever. Eventually, something will intrude, exposing securities' imperfections and too-high prices. Prices will decline. Investors will like them less at $60 than they did at $100. Fear of losing the remaining $60 will overtake the urge to make back the lost $40. Risk aversion eventually will reassert itself (and usually go to excess).

How about some quantification of this cycle? In mid-1998, just before the collapse of Long-Term Capital Management brought investors other than techies to their senses, only **$12.5 billion** of non-defaulted bonds yielded more than 20% (one possible threshold for the label "distressed debt"). Because investors weren't very worried about risk, they demanded ultra-high returns from relatively few non-defaulted bonds; the word "blithe" might best describe their attitude.

But Long-Term's demise awakened investors to the existence of risk, and a year later, the amount of bonds yielding more than 20% had more than tripled to **$38.7 billion**. By mid-2002, when the corporate scandals held the debt market in a grip of terror, the 20% yielders had grown to **$105.6 billion**, eight and a half times the level just four years earlier. Risk aversion had come a long way from inadequate and, as later events showed, had become excessive. By March 31, 2004, this figure had fallen 85%, to just **$16.2 billion**; risk aversion had subsided (and possibly had become inadequate again). I'm sure that fundamentals didn't fluctuate anywhere near the degree reflected in prices, yields and thus the distressed debt tally. As usual, reality was greatly exaggerated by swings in psychology.

When investors in general are too risk-tolerant, security prices can embody more risk than they do return. When investors are too risk-averse, prices can offer more return than risk. For me, Warren Buffett's quote best sums up this phenomenon and the contrarian position that is required as a result: **"The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."**

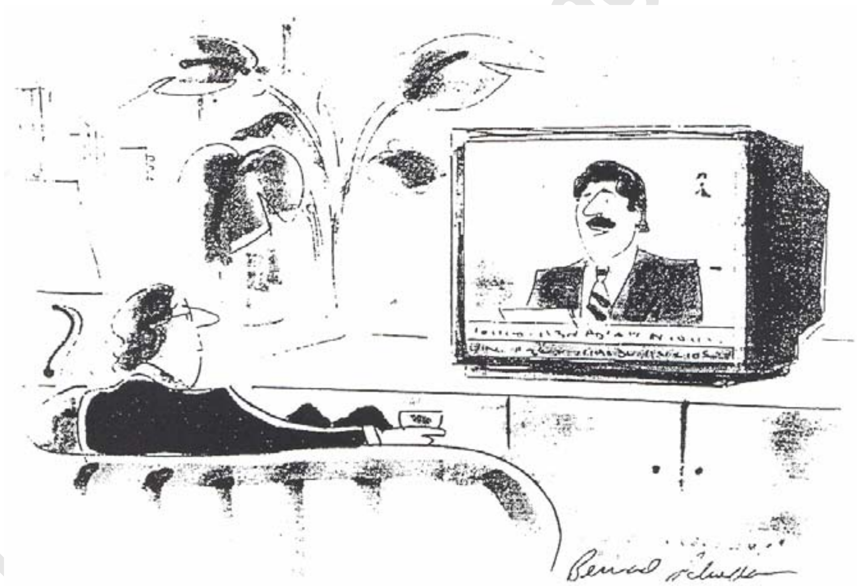
<u>Full or Empty</u>

One of the most volatile cycles relates to the willingness of investors to interpret events positively or negatively. Forget the traditional half measures; investors see their glass completely full at some times and totally empty at others.

It isn't nonsensical for assets to be viewed differently at different times. After all, almost everything incorporates elements of both good and bad. But there are times when investors seem to look only at the positives or only at the negatives. **As a result, there are times when there seems to be no price so high that investors won't pay it, and these inevitably are followed by times when no price is low enough to convince people to buy.**

This oscillation – from viewing a security, a company or an investment technique as "flawless" to viewing it as "worthless" – has occurred several times during my time in the investment business, with the predictable effect on prices.

This "full-or-empty" phenomenon is particularly apparent in media savants' explanations for each day's market movement. In "up" times, a strong report on consumer income is interpreted as fueling corporate sales and profits, and thus is used to explain rising stock prices. In "down" times, on the other hand, the same report may be cited as a cause of inflationary pressure, rising interest rates, lower p/e ratios, and thus declining stock prices.



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

<u>Valuing the Future – Credence or Skepticism</u>

Some investors spend their time working hard to quantify this year's earnings and the growth thereafter. Others strive to value real assets, intellectual property and business advantages (and predict what others will pay for them). Still others try to deduce the value implications of mergers and acquisitions, balance sheet restructurings and private-to-public transactions. **In all of these ways and many more, it's the job of those in the investment business to predict the future and put a value on it.**

In 2000-01, our distressed debt funds invested a few hundred million dollars in bankrupt telecom companies. In each case, the purchase price implied a value for the company that was a small fraction of the amounts that had been invested in hard assets such as switching gear or fiber-optic cable. If we could resell the equipment for a higher percentage of its cost than we had paid, the investment would be profitable.

The first sale went well, and we made a quick 50%. But soon thereafter, people stopped showing up to bid on these assets. Whereas the party to whom we had sold the first company thought he had a bargain, in later instances the possible buyers shied away from assets that were turning out to be in heavy oversupply. And that brings me to my point. In 1999, investors accepted at face value their telecom companies' rosy predictions of the future and paid handily for that potential. In 2001, they saw the potential as largely empty and wouldn't pay a dime for it, given that the industry's capacity vastly exceeded its current needs and no one could imagine the excess being absorbed in their lifetime. **This cycle in investors' willingness to value the future is one of the most powerful that exists.**

A simple metaphor relating to real estate helped me to understand this phenomenon: **What's an empty building worth?** An empty building (a) has a replacement value, of course, but it (b) throws off no revenues and (c) costs money to own, in the form of taxes, insurance, minimum maintenance, interest payments, and opportunity costs. In other words, it's a cash drain. When investors are in a pessimistic mood and can't see more than a few years out, they can only think about the negative cash flows and are unable to imagine a time when the building will be rented and profitable. But when the mood turns up and interest in future potential runs high, investors envision it full of tenants, throwing off vast amounts of cash, and thus salable at a fancy price.

Fluctuation in investors' willingness to ascribe value to possible future developments represents a variation on the full-or-empty cycle. Its swings are enormously powerful and mustn't be underestimated.

<u>Value Investing vs. Growth Investing – (or Value Today vs. Value Tomorrow)</u>

Interest in "value investing" versus "growth investing" is another phenomenon that fluctuates over time, with the relative popularity of growth investing based heavily on investors' willingness to value the future. It's not just a random fad, but a reflection of a cycle in attitudes.

In my view, all investors try to buy value – that is, to buy something for less than it'll turn out to be worth. The difference between the two principal schools of investing can be boiled down to this:

> "Value investors" buy stocks (even those whose intrinsic value may show little growth in the future) out of conviction that the current value is high relative to the current price.
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> "Growth investors" buy stocks (even those whose current value is low relative to their current price) because they believe the value will grow fast enough in the future to produce substantial appreciation.

Thus, it seems to me, the choice isn't really between value and growth, but between value today and value tomorrow. Growth investing represents a bet on company performance that may or may not materialize in the future, while value investing is based primarily on analysis of a company's current worth.

Certainly much of the fluctuation in the performance of one school versus the other stems from their relative price attractiveness: one group of stocks may be perceived as the cheaper of the two and thus begin to be bought more strongly. This buying makes it appreciate relative to the other until it gets ahead price-wise, and then it declines (or at least pauses) while the other catches up.

But the two schools' relative performance also depends to a great extent on attitudes that fluctuate cyclically. Optimistic growth investors with big dreams for the future bid up the stocks of companies that they expect to exhibit rapid growth, as they did in 1998-99. Eventually their buying power is spent, their hopes are dashed, or their optimism wanes. Then value investors with their more limited expectations regarding the future have their day in less buoyant times, as they did in 2000-01.

Selling Panic (and Its Less-Recognized Brother)

As the pendulum makes its periodic swing from positive to negative, the resurgence of fear, risk aversion, and attention to things missing from the glass combine to bring down prices. Most investors see their resolve evaporate, along with all their reasons for holding the things in their portfolios. They go from being confident partisans, to worriers, eventually to sellers – and sometimes to panic sellers.

In November 2000, I wrote about "A Framework for Understanding Market Crisis," an insightful article by Richard Bookstaber, then of Moore Capital Management, that analyzed the behavior of panic sellers. Rather than reinvent the wheel, I'll excerpt from my earlier memo:

- Most people think security price movements result primarily from the market's discounting of information about corporate, economic or geopolitical events – so-called "fundamentals." If you sit with a trader, however, it's easy to observe that prices are always moving in response to things other than fundamental information.

- Bookstaber says, "the principal reason for intraday price movement is the demand for liquidity . . . . In place of the conventional academic perspective of the role of the market, in which the market is efficient and exists solely for informational purposes, this view is that the role of the market is to provide immediacy for liquidity demanders . . . . **By accepting the notion that markets exist to satisfy liquidity demand and liquidity supply, the framework is in place for understanding what causes market crises, which are the times when liquidity and immediacy matter most."**

- "Liquidity demanders are demanders of immediacy." I would describe them as holders of assets in due course, such as investors and hedgers, who from time to time have a strong need to adjust their positions. When there's urgency, "the defining characteristic is that time is more important than price . . . . **they need to get the trade done immediately and are willing to pay to do so.**"

- Usually when the price of something falls, fewer people want to sell it and more want to buy it. But in a crisis, "market prices become countereconomic," and the reverse becomes true. **"A**

falling price, instead of deterring people from selling, triggers a growing flood of selling, and instead of attracting buyers, a falling price drives potential buyers from the market (or, even worse, turns potential buyers into sellers.)" This phenomenon can occur for reasons ranging from transactional (they receive margin calls) to emotional (they just get scared). The liquidity demanders increase in number, and they become more highly motivated.

- In times of crisis, liquidity suppliers become scarce. Maybe they spent their capital in the first 10% decline and are out of powder. Maybe the market's increased volatility and decreased liquidity have reduced the price they're willing to pay. And maybe they're scared, too. **"Information did not cause the dramatic price volatility. It was caused by the crisis-induced demand for liquidity at a time that liquidity suppliers were shrinking from the market."**

Speaking of panics, we all recognize the carnage that occurs when the desire to sell far exceeds the willingness to buy. But I think Bookstaber's analysis applies equally to the opposite – times when the desire to buy outstrips the willingness to sell. It amounts to a "**buying panic"** and represents no less of a crisis, even though – because the immediate result is profit rather than loss – it is discussed in different terms. **Certainly 1999 was just as much a year of irrational, liquidity-driven crisis as was 1987.**

And clearly, both selling panics and buying panics have more to do with extreme swings in emotion and urgency than they do with fundamental corporate and economic developments.

<u>The Credit Cycle</u>

I couldn't leave the subject of cycles without touching on one of the most pronounced, the credit cycle. From time to time, providers of capital simply turn the spigot on or off – as in so many things, to excess. There are times when anyone can get any amount of capital for any purpose, and times when even the most deserving borrowers can't access reasonable amounts for worthwhile projects. **The behavior of the capital markets is a great indicator of where we stand in terms of psychology and a great contributor to the supply of investment bargains.**

The level of security issuance varies over time in a wave-like pattern, and the swing from high years to low years can be great. I don't believe a high level of issuance says much about the desire of companies to raise money; usually they'll take all that's available. Rather, a high level of issuance indicates a willingness on the part of investors to buy increased amounts of securities, something that varies greatly depending on their mood.

But equally important is the trend in the quality of new issue securities. **It is my belief that a willingness to buy new securities in <u>greater quantity</u> invariably is accompanied by a willingness to buy securities of <u>lower quality</u>**. Thus lower standards go hand in hand with higher amounts of issuance. When investors are chastened and afraid, they'll buy very few new securities, and only those of high quality. When they're euphoric and confident, they'll buy greater quantities and attend less to matters of quality and downside protection. **In the most overheated markets, when being underinvested is considered the biggest mistake one can make, buyers compete for new issues by paying higher prices and by demanding less in terms of quality and safety.**

It's in this way that the swing of the capital market pendulum to one extreme provides the energy for the swing back toward the other. For example, with terrified high yield bond investors hugging the sidelines in 1990-91, low issuance and a great degree of investor selectivity set the stage for low subsequent default rates and excellent portfolio performance. Double-digit returns in 1991-97 (save 1994) turned investors from cautious to confident and attracted increased capital for investment in high yield bonds. These conditions led to the issuance of bonds in greater quantity and lower quality in 1997-99. And, of course, that issuance contributed to record default rates in 2001-02, to great portfolio losses, and eventually to enormous returns on the rebound. And so the cycle goes on.

From the depths reached in the summer of 2002, the recovery of investor sentiment has been dramatic in both its extent and its speed. And with that recovery has come yet another dramatic swing of the capital cycle from restrictive to accommodating. Again as seen through the example of high yield bonds, the last eighteen months have witnessed a near-record amount of new bond issuance, including a large number of CCC-rated bonds, bonds with weak covenants, and bonds issued to fund payments to equity holders.

All net debt incurrence adds to a company's riskiness, in that it increases balance sheet leverage. But at minimum the proceeds, or assets bought with the proceeds, should stay within the company. When debt is raised and the proceeds go out the door without enhancing the value of the company, a transaction should be viewed with a particularly critical eye. The fact that a substantial number of bonds-for-dividends deals could be done in recent months says a lot about where we stand in the credit cycle . . . and about the likelihood that some of these deals will be grist for distressed debt investment in the future.

Looking for the cause of a market extreme usually requires rewinding the videotape of the credit cycle a few months or years. Most raging bull markets are abetted by an upsurge in the willingness to provide capital, usually imprudently. Likewise, most collapses are preceded by a wholesale refusal to finance certain companies, industries, or the entire gamut of would-be financers.

The capital market oscillates between wide open and slammed shut. It creates the potential for eventual bargain investments when it provides capital to companies that shouldn't get it, and it turns that potential into reality when it pulls the rug out from under those companies by refusing them further financing. It always has, and it always will.

Just Give Me My 10%

Putting it all together, the fluctuations in attitudes and behavior described above combine to make the stock market the ultimate pendulum. In my 34 full calendar years in the investment business, starting with 1970, the annual returns on the S&P 500 have swung from plus 37% to minus 26%. Averaging out good years and bad years, the long-run return is usually stated as 10% or so. Everyone's been happy with that typical performance and would love more of the same.

But remember, a swinging pendulum may be at its midpoint "on average," but it actually spends very little time there. The same is true of financial market performance. Here's a fun question (and a good illustration): for how many of the 34 years from 1970 through 2003 was the annual return on the S&P 500 within plus or minus 2% of "normal" – that is, between 8% and 12%?

I expected the answer to be “not that often,” but I was surprised to learn that it had happened **only once!** It also surprised me to learn that the return had been more than 20 percentage points away from “normal” – either up more than 30% or down more than 10% – two-thirds of the time: 22 out of the last 34 years. So one thing that can be said with conviction about stock market performance is that **the average certainly isn’t the norm.** Market fluctuations of this magnitude aren’t nearly fully explained by the changing fortunes of companies, industries or economies. They’re largely attributable to the mood swings of investors.

Lastly, the times when return is at the extremes aren’t randomly distributed over the years. Rather they’re clustered, due to the fact that investors’ psychological swings tend to persist for a while – to paraphrase Herb Stein, they tend to continue until they stop. Not one of those 22 extreme up or down years was more than a year away from another year of similarly extreme performance **in the same direction**.

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So from time to time we see rabid buyers or terrified sellers; urgency to get in or to get out; overheated markets or ice-cold markets; and prices unsustainably high or ridiculously low. **Certainly the markets, and investor attitudes and behavior, spend only a small portion of the time at “the happy medium.”**

What does this say about how we should act? Joining the herd and participating in the extremes of these cycles obviously can be dangerous to your financial health. **The markets’ extreme highs are created when avid buyers are in control, pushing prices to levels that may never be seen again. The lows are created when panicky sellers predominate, willing to part with assets at prices that often turn out to have been grossly inadequate.**

“Buy low, sell high” is the time-honored dictum, but investors who are swept up in market cycles too often do just the opposite. The proper response lies in contrarian behavior: buy when they hate ‘em, and sell when they love ‘em. “Once-in-a-lifetime” market extremes seem to occur just once in a decade or so – not often enough to build an investment career around capitalizing on them. But attempting to do so should be an important component of any investor’s approach.

Just don’t think it’ll be easy. You need the ability to detect instances in which prices have diverged significantly from intrinsic value. You have to have a strong-enough stomach to defy conventional wisdom (one of the greatest oxymorons) and resist the myth that the market’s always efficient, and thus right. You need experience on which to base this resolute behavior. And you must have the support of understanding, patient constituencies. Without enough time to ride out the extremes while waiting for reason to prevail, you’ll become that most typical of market victims: the six-foot tall man who drowned crossing the stream that was five feet deep on average. **But if you’re alert to the pendulum-like swing of the markets, it’s possible to recognize the opportunities that occasionally are there for the plucking.**

July 20, 2004