

Memo to: Oaktree Clients

From: Howard Marks

Re: The Tide Goes Out

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For every period, there's a quotation which serves perfectly to explain what's going on, and I often find myself borrowing it. Warren Buffett provides more than his share; not only is his insight unmatched, but so is his ability to express it. Thus, starting with "It's All Good" last July, I've found frequent use for this one:

When the tide goes out, we find out who's been swimming without a bathing suit.

**Certainly, "swimming without a bathing suit" – or perhaps a life preserver – serves beautifully to describe investor behavior during the carefree period that ended last summer. And equally, the ebbing of the tide – and the exposing of those who engaged in that behavior – sums up the unpleasant disclosures which have taken place since.** Financial sector participants indulged in unprecedented amounts of leverage, innovation and risk taking between late 2002 and mid-2007, the consequences of which have become readily apparent.

#### Leveraging and Inflating

When we look at the last few years, we see a rather ordinary period of economic growth and prosperity, accompanied by good corporate health and profitability. **But what distinguished this period from all others was a runaway boom in financial sector activity.** The whole financial sector inflated, like a balloon into which increasingly more hot air was forced.

The greatest contributor to the 2002-07 boom likely was leverage; the recent past saw a steady flow of equity capital to levered entities, accompanied by willingness on the part of lenders to provide unprecedented amounts of leverage. Now the reversal of that process is underway, with consequences that are equally dramatic but much less pleasant.

Let's review the process which was often described and embraced as a virtuous circle:

- Equity capital was provided to would-be leveraged entities.
- Debt was readily available for them to use in expanding their total capital and thus their ability to pursue profit.
- This combined capital was used to purchase assets, forcing prices higher.
- Price appreciation caused the entities' equity to expand at a faster rate thanks to their financial leverage.

- The increases in equity were matched by further increases in borrowings.
- In fact, the good performance convinced lenders to increase the amount of leverage they would supply per dollar of equity. This meant the entities could grow their portfolios even faster than the rates at which equity capital flowed in and assets appreciated.
- Further, because of the seeming impregnability of the leveraged entities' profitability, risk aversion shrank and the risk premiums and returns demanded by lenders declined. Leverage became cheaper and thus even more attractive.
- As is typical of virtuous circles, everything ran smoothly . . . for a while: additional equity flowed in; it was leveraged up increasingly; buying caused assets to appreciate further; and the upward spiral continued.

**With things working increasingly well and investors becoming more and more excited, processes like this one seem destined to go on forever. Of course, they cannot. But people forget that, satisfying one of the key prerequisites for a cycle that goes to excess. Overestimating the longevity of up legs and down legs is one of the mistakes that investors insist on repeating.**

#### Deleveraging and Deflating

**Over the years I've written a number of memos about cycles, and in each one I've tried to remind readers that trees don't grow to the sky, and that success carries within itself the seeds of failure.** Just as the balloon of levered entities expanded beyond reason in the last few years, now it's well into the process of deflating. And, as I mentioned in "Now What?" the air always goes out a lot faster than it went in.

**Eventually, developments that are exogenous to the process interfere, or perhaps the process collapses of its own weight.** In the current instance, consider subprime mortgages. The process described above was going along just fine, with increasing numbers of ever-larger mortgages being granted to cover a rising percentage of the cost of houses bought at rising prices by borrowers of declining creditworthiness. So far, so good: a process unhampered by discipline or restraint. But it must be seen that, eventually, reality will intrude. For example, eventually the amounts borrowed will necessitate payments that exceed what the borrowers can afford. **Oops; investors forgot that part.**

To understand what's going on now, all you have to do is reverse the process described above and squeeze (the squeeze – the force behind the deflating – comes from the pain that accompanies disclosure of the process's flaws).

- Something causes asset prices to weaken.
- Now the leverage works in reverse, causing the entities' equity to shrink faster than the rate of decline in asset prices, and their ratios of borrowings to assets to rise.
- Lenders, worried about declining asset prices, either call in their loans or refuse to roll over debt when it matures. In some cases, the entities' now-shrunk collateral fails a

market value test and triggers a margin call, which can be met only through the posting of additional collateral (which usually isn't available) or sales of assets (which add to market weakness).

- Further, with the world suddenly feeling much riskier, lenders demand increased risk premiums, raising the cost of borrowed funds and further impairing borrowers' economics.
- Equity investors – panicked by the combination of asset price declines, leveraged equity losses and margin calls – withdraw equity capital to the extent they can. The sight of investors lining up at the withdrawal window, and often being told they can't have their money, adds to the negative climate.
- The need to raise cash with which to satisfy the demands of lenders and equity investors places further downward pressure on asset prices, reinforcing what is suddenly a vicious circle. Fire sales of collateral add to this pressure.
- In particular, think what happens to banks. In this negative environment, it's hard to imagine these highly leveraged entities extending credit, given that (a) banks' equity is shrinking, (b) they feel they may need the money themselves, and (c) they fear further losses on loans and assets.

It shouldn't come as a surprise that this vicious circle seems as obvious and inescapable as did the virtuous one just a short time earlier. This is the point at which we may start to hear talk about the unstoppable downward spiral and thus the pending collapse of the financial system. **Unquestioning euphoria gives way to full-blown depression.**

### Mark-to-Market Accounting

If you watch enough cop shows on TV, you know that investigators of suspicious fires use the term "accelerant" for the chemical used by an arsonist to encourage the spread of a blaze. The current capital market cycle has been accelerated by an element that was added to the capital market equation in the 1990s: mark-to-market accounting.

In the simpler but still not totally stable financial world I entered forty years ago, stability was desired in financial institutions. So, for example, banks and insurance companies were allowed to carry a loan or a bond at cost on their balance sheets as long as it was (a) fundamentally unimpaired and (b) intended to be held to maturity. Even if its market value fell temporarily, it was assumed that a creditworthy claim would be repaid in full at maturity. Thus, price fluctuations were ignored as long as fundamentals were sound.

**More recently, "transparency," "accountability" and "market signals" became more highly prized.** A lot of this had to do with skullduggery unearthed at companies like Enron. As a result, accounting increasingly came to require that assets be valued at actual or estimated market prices. I'd had a preview of this in 1990 when, as part of efforts to "get" the high yield bond industry (and Drexel and Milken), S&Ls were required to market price their holdings of high yield bonds – dooming many of them in a time of price weakness.

There is no perfect accounting standard – just choices, with each alternative stronger on some desired traits but weaker on others. “Cost” is objective but often out of date and far from accurate. “Lower-of-cost-or-market” is conservative but asymmetrical in its error. “Market value” is contemporary but not always reliable; it discloses value declines faster than Enron did, but it also requires subjective judgments and bakes in price fluctuations that may prove transitory. **So when accounting regulators mandated mark-to-market, they decided in favor of currentness and transparency but against stability with regard to marketable securities and objectiveness with regard to privates.**

(When we began to organize closed-end funds in 1988, and for about fifteen years thereafter, Bruce and I established a policy for valuing privates based on “cost unless there’s been a change which is fundamental, material and permanent.” We felt it served us well. But since Enron and Sarbanes-Oxley, we’ve been forbidden to use that approach. Now funds are required to price each asset based on opinions regarding its worth. We preferred the old way. Who’s better served now?)

Mark-to-market accounting turns out to be one of the main contributors to the current boom/bust cycle. In the old days, a bank (for example) would have carried assets at cost. In this decade’s up years, since that bank was required to mark them to market, it was able to expand its balance sheet, and thus its operations, as assets appreciated in the virtuous circle. Equally, contracting asset values now mean the bank’s portfolio is worth less, and that its equity is smaller and can support less debt and thus less lending. Loan portfolios have to be reduced, and new loans can’t be made. A bank’s regulatory capital can become insufficient; it’s this, in part, that has been behind the banks’ trips to sovereign wealth funds for re-equitization.

**Since they operate in a world that combines rigid regulatory capital requirements, high leverage, fluctuating asset prices and, now, mark-to-market accounting, financial institutions can fail to be viable in extreme bear markets.** (And as *The Wall Street Journal* of March 6 said, “What’s the difference between a hedge fund and a bank? Banks are more highly leveraged.”)

In 1990, when high yield bonds had the brush with difficulty described above (meaning spreads widened to 1,100 basis points, and a law was passed that required S&Ls to reflect price declines on their balance sheets), I was asked to brief the board of TCW on the risks. I presented a parable about a regulated financial institution that went bankrupt under the weight of mark-to-market accounting. I joked with Bill Spencer, who was president of Citibank when I worked there, that in the 1980s, that could have been Citibank if it was required to recognize mark-to-market losses on real estate loans. **Guess what: today that’s the rule.**

This raises one of my favorite questions: **what’s an asset’s price?**

- Is it what you could get for it if you wanted to sell it?
- Is it what you would have to pay to buy it?
- Is it the price to buy or sell \$1 million worth, or \$100 million worth?

- Is it the likely proceeds from the patient sale of an asset in isolation, or what you'd get for it as part of a large portfolio that has to be liquidated in one day?
- Is it the price in today's chaotic market, or what the price would be in a calmer one? And if the latter, who says what that is?
- Is it Goldman's price or Morgan's? Or the average of the two? And what if you find out that Lehman's is lower than both of them?
- What's the price if the asset doesn't trade? Or if you hold the whole thing and have no intention to sell?

**I don't have the answer. Mainly because there is no answer. In short, an asset doesn't have "a price." It has many possible prices, and no one can say which is the right one.** The ads for a jeweler here in Los Angeles lead with a great headline: "guaranteed to appraise for more." In other words, either (a) he sells jewelry for less than it's worth (and, if so, why?), or (b) he sells things for what they're worth but guarantees they'll appraise for more, which makes you wonder about the appraisals. The way I see it, the appraisals he touts are just as meaningless as many of the "market prices" being used today to price assets at banks, hedge funds, CDOs and CLOs.

A view has begun to be expressed that mark-to-market accounting – in conjunction with the vicious circle that prevails today – is causing asset values to be understated, writeoffs to be overstated, and the credit crisis to be exaggerated. Certainly there's every reason to believe that:

- Assets are being valued based on what people will pay for them (which is the goal), but with few people in a buying mood, market prices can far understate value.
- Supply and demand have completely supplanted fundamentals in determining prices.
- With little trading taking place, assets are often priced via reference to indices. But those indices fluctuate wildly in connection with speculation and hedging activity, and they may have little relevance to the individual asset being priced.
- Lenders are switching their valuations of collateral from going concern basis to liquidation basis.
- Margin calls are resulting in liquidations, which depress prices, leading to more margin calls.

**It's hard to believe these are really the bases on which financial institutions should value their trillion-dollar balance sheets.** But we're stuck for now with mark-to-market accounting. At minimum, you should expect it to contribute extensively to continued volatility. Believe me, it already has.

"Should" ≠ "Will"

Lately I've enjoyed comparisons of recent developments to Frankenstein's loss of control over his monster, or to a man-made mutation that has escaped from the laboratory. Extensive financial sector experimentation took place involving unprecedented combinations of volatile elements such as leverage, securitization, tranching, derivatives

and mark-to-market accounting. In the lab, experimental microbes would be quarantined until their dangers were fully understood. In the financial markets of this decade, on the other hand, they were rapidly popularized and peddled world-wide.

In 1998, Long-Term Capital Management became the poster child for the ability of sophisticated investment strategies to malfunction with grave consequences. This hedge fund invested in a highly diverse portfolio of fixed income arbitrage positions. These were situations where two related assets were trading in violation of their normal price relationship: one was a little more expensive relative to the other than history said it should be. LTCM bought into these small mispricings in large quantities, on enormous leverage, in the expectation that they would correct. The explanation for its subsequent meltdown was simple, according to the founder, John Meriwether: “The Fund added to its positions in anticipation of convergence, yet . . . the trades diverged dramatically.”

**For years these memos have quoted my good friend, Bruce Newberg, as saying, “Improbable things happen all the time, and things that are supposed to happen often fail to do so.” Acting in excessive reliance on the fact that something “should happen” can kill you when it doesn’t.** That’s why I always remind people about the 6-foot-tall man who drowned crossing the stream that was 5 feet deep on average. You have to be able to get through the low points. And the success of your investment actions shouldn’t depend on normal outcomes prevailing; instead, you must allow for outliers.

Recent tales from the bust include a number of disasters that arose because things didn’t work as they were supposed to:

- Although defaults **should** be independent, subprime-related securities collapsed when mortgage borrowers all over the country began to default at the same time.
- Auction rate notes should have delivered the benefits of both long-term financing (permanence) and short-term financing (low rates), because frequent rate resets **should have** eliminated the price risk that accompanies fixed-rate long-term debt holdings. But the reset process failed to work when the auctions attracted no bidders.
- At the top in commercial real estate during the second quarter of 2007, real estate investors were willing to buy New York office buildings at 3½% cash yields (with money borrowed at 5½%) because (a) rents **should** double to \$150 sq. ft./year or, anyway, (b) someone else **should** be willing to pay more for it. So far . . . no.
- “Absolute return funds” **should** provide steady returns without vulnerability to market fluctuations. It turned out, however, that only completely hedged vehicles are completely without market correlation, and now a good absolute return fund may be one that goes down only half as much.
- A London hedge fund called Peloton gained 87% in 2007 and was named Credit Hedge Fund of the Year in January. Its long positions in AAA mortgage paper **should have** continued to hold up better than its subprime shorts. But the AAAs declined this year, and they’d bought enough on leverage to make the fund melt down in February.
- Credit default swaps **should** serve as a great way to transfer credit risk. But the market grew out of control – to \$40-odd trillion of insurance coverage on \$6 trillion

of debt – and no one knows just how it'll all work out. When CDS are traded around, the people who bought coverage have no way of knowing if their insurers' capital is adequate. Thus, efforts to off-load credit risk may have replaced it with "counterparty risk."

**Clearly, investors only make investments because they expect them to work out, and their analysis will center on the likely scenarios. But they mustn't fixate on that which is supposed to happen to the exclusion of the other possibilities . . . and load up on risk and leverage to the point where negative outcomes will do them in.**

**At the same time, however, it's very hard to figure out how broad the range of considered possibilities should be.** No investment action can withstand every possible development. Is there really such a thing as a "worst case assumption" short of a total loss? I often find myself asking one of the classic questions in investing: **How much effort and capital should we devote to preparing for the improbable disaster?**

Many of the recent problems occurred because investors expected outcomes other than the ones that arose. Had they been too optimistic? Or did the environment simply throw curves that no one should have been expected to handle?

### Leverage and Risk

Two important investment principles should be embraced concerning leverage and risk:

**First, leverage magnifies outcomes but doesn't add value.** I've said that so often that I ought to stop. But just a few reminders:

- Leverage magnifies losses as well as gains. In Las Vegas, they say, "The more you bet, the more you win when you win." But they always forget to add ". . . and the more you lose when you lose." **Leverage is just a way to bet more.**
- Leverage magnifies outcomes but doesn't add value. It will make for higher highs and lower lows, and it might even produce an increase in the expected value . . . assuming outcomes are normal. But it can't make something a fundamentally better investment. **Thus, leverage absolutely cannot be equated to the contribution to return that comes from skill in selecting investments or in restructuring company operations or finances.**
- From time to time, people come up with structures that are purported to add to an investment's upside without adding proportionally to its downside. They rarely work. Or, expressed properly, **it makes no sense to expect them to enhance the expected return without increasing the range of outcomes and the risk of loss.** You may be able to take an investment with a 10% promised return and turn it into a vehicle that has a 90% chance of earning 13% and a 10% chance of losing everything. **But can**

**you end up with something that has a higher expected return but isn't riskier?  
That's too good to be true.**

- Finally, in addition to magnifying losses as well as gains, **leverage carries an extra risk on the downside that isn't offset by accompanying upside: the risk of ruin.** Leverage, when added to losses, can lead to margin calls and meltdowns. There is no corresponding benefit. This lesson is being well learned today.

**Second, every investment or portfolio entails a variety of risks, and its overall risk is the sum of those.**

Every investment embodies both the specific risk related to the individual company or asset and the systematic risk that is a function of its membership in a market – its beta. There also can be liquidity risk, legal risk, currency risk and political risk. Finally, risk is introduced by the structure in which an asset is held. Here I'm referring to the risk that comes with leverage.

**To simplify for my current purpose, risk comes from the combination of what you buy and how you finance it.** You can buy very risky assets, but if you don't lever up to do so, you'll never lose them to a margin call. Or you can buy fundamentally safe assets, but the combination of enough leverage and a sufficiently hostile environment can cause a meltdown. **In other words, investing in "safe" assets isn't necessarily safe, particularly if you've borrowed to buy them.**

We've seen this at work in recent days, as entities that invested in top-quality assets have run into trouble. For example, Carlyle Capital Corp. ("CCC") invested in AAA-rated debt of the two government-sponsored housing agencies, Freddie Mac and Fannie Mae. But it levered its equity 31 times to do so, buying \$21.7 billion of securities on the basis of just \$670 million of equity. That meant that if values declined 3%, its equity would be gone. Worried bankers pulled back their loans; CCC received margin calls it couldn't meet; the banks seized its assets; and the fund melted down.

Investment safety doesn't come from doing safe things, but from doing things safely. Put another way, anything can be screwed up by using so much leverage that its fluctuations can't be survived. That's why, in writing about LTCM in "Genius Isn't Enough" (January 1999), I said **leverage + volatility = dynamite.**

### Financial Self-Destruction

The dramatic cyclical up leg of nearly five years (I'd say November 2002 through June 2007), as well as the far shorter but equally dramatic down leg that started last summer, have given me opportunity to reflect on a number of phenomena to be noted and lessons to be learned. You've seen the results in the last three memos ("No Different This Time," "Now What?" and "Whodunit"). I've reached a new view of how some things work, based on tying together several separate observations.



- **I've pointed out that one of the reasons models can fail to work is because markets are dynamic, not static.** Through frequent play, you can increase your mastery over a golf course, as you learn the consequences of each action and thus which are the right ones: if you hit the ball to spot A it'll roll toward the hole, whereas if you hit to spot B it'll roll toward the water. Eventual mastery is possible because the golf course doesn't change in response to your play. But fixing on tactics through which to master a market is unavailing, because the market is shaped by those who participate in it, and thus it responds and changes. No course of investment action – even if executed perfectly – can be right for all markets and all times. **In fact, when an approach becomes too well accepted, the widespread reliance on it becomes a source of danger.**
- I've devoted a lot of ink to Wall Street's innovation of financial products. Innovation becomes possible in up markets, when optimistic investors:
  - think about what might work and dismiss the likelihood of failure,
  - are willing to give something new the benefit of the doubt,
  - are impressed by early, easy successes, and
  - fear the consequences of failing to emulate competitors who enjoy those successes.

**In the last five years, these factors abetted unprecedented financial innovation, as quants assured prospective investors that the “fat-tail” events that could cause the new products to fail were most unlikely to occur.**

- **But while the quants' predictions usually center on the high probability that events will fall within the normal range, the last nine months have given all of us the opportunity to witness events at the extreme.** This started last summer, when “once-in-a-lifetime events” became common. David Viniar, CFO of Goldman Sachs, may be remembered for saying in August that “we were seeing things that were 25-standard deviation moves, several days in a row.” It's unusual for 100-year floods to become daily occurrences, but sometimes they do.
- **Finally, I've reminded readers about past bull market innovations that promised miracles but often failed when tested in bear markets.** One of the most easily recognized of these is “portfolio insurance.” PI was a statistically derived technique that would enable equity exposure to be increased without a commensurate increase in risk. This was made possible by a process through which computer-generated sell orders would be implemented automatically in the event of a market decline, instantaneously scaling back portfolio risk. PI had its heyday in the period just before “Black Monday.” But then, on October 19, 1987, the U.S. stock market declined 20%; beleaguered brokers didn't answer their phones; the sell orders weren't implemented; and PI ceased to be heard of.

A few months ago, the twentieth anniversary of Black Monday gave me the opportunity to reflect on the short life of portfolio insurance. **I began to think – and now I’m convinced – that PI didn’t fail because Black Monday just happened to occur. Rather, it contributed to Black Monday’s occurrence, and thus to its own demise.**

In my December memo “No Different This Time” I listed twelve lessons of 2007. Number four said that “widespread disregard for risk creates great risk.” **In that way, in 1987 the widespread belief that equity exposure could be increased without similarly increasing risk led to an unjustified – and unsustainable – expansion of equity allocations. And the carefree buying this generated led to elevated stock prices from which a retreat was increasingly likely.** When the S&P 500 fell 10% on the Wednesday-Friday leading up to Black Monday and users of PI had the weekend to think things over, it seems they concluded that they had accepted too much risk; that they couldn’t depend on PI to save them; and that they had to dump stocks en masse. **Thus, this innovation was not undone by a chance event. Its undoing was brought about by an event which it had, at least in part, caused.**

Innovation generally requires bullish assumptions, and thus it’s easily accomplished in bullish times. Those optimistic assumptions add to the risk in the environment, and when eventually proved to be too rosy, they contribute to losses and to the products’ failure. **The naked swimming which is encouraged by the rising tide certainly is exposed when the tide goes out. But I’d go further: in the dynamic environment of the marketplace, naked swimming eventually can cause the tide to go out.**

### A New Kind of Crisis

People ask me whether things look familiar, and how this cycle compares to others I’ve experienced. I tell them this one’s different in both degree and kind.

We’ve had collapses in the past, but never so broad-gauged and systemic. The earlier ones were the result of things going on in specific sectors or regions: LBO debt in 1990, real estate in 1992-94, emerging markets in 1997-98, and tech/telecom stocks in 2000-02. Most people would prefer to see the weakness centered in specific areas . . . and thus containable, treatable and avoidable.

This bust isn’t sector-based, although it was ignited first in subprime mortgages. Instead, it stems from the broad application of the techniques I’ve been discussing: leverage, securitization, tranching and derivatives. Because Wall Street applied those techniques in so many ways, the current problems are generalized and pervasive and have the ability to cause losses in a wide variety of areas, irrespective of the underlying fundamentals.

The current bust arose against a backdrop of healthy fundamentals. The economy was growing. Commercial real estate wasn’t overbuilt. Bond defaults were at record lows. Yet huge markdowns have taken place in these areas. Thus the solution will not come

from addressing localized fundamental problems. Instead, the problem is hydra-headed, affecting a large number of areas due to contagion. Larry Summers put it this way:

You have three vicious cycles going on simultaneously. A liquidity vicious cycle -- in which asset prices fall, people sell and therefore prices fall more; a Keynesian vicious cycle -- where people's incomes go down, so they spend less, so other people's income falls and they spend less; and a credit accelerator, where economic losses cause financial problems that cause more real economy problems.

**There is no schematic diagram for the workings of the economy and the markets, as in “if we do A, the result will be B.”** That’s particularly true for the current crisis, since some of the financial techniques that gave rise to it are new; others haven’t been used to the same extent; and they’ve never been combined as they were in the last few years. **In particular, the workings of economies and markets depend heavily on psychology, which can’t be treated as if it’s hard-wired.** Thus the people trying to address this bust can only work from hypotheses and try possibilities.

The Fed and the administration are determined to solve the problem, but we’re unlikely to have the unwind we need without pain. As I wrote in “Whodunit,” in order for efficient capital allocation decisions to be made, an economic system that aims to create capital has to witness capital destruction from time to time. Efforts to avoid the pain would cause problems like unrecognized bad loans to linger, delaying a solution. **I’m no expert, but it makes sense to me that the quantum of pain on the way down has to at least approach the pleasure everyone felt during the boom.**

**Other than just through the passage of time, the solution to the credit crunch – to the extent there is one – might be found in short-circuiting the deleveraging process described on pages 2 and 3.** Thus, the authorities will try to get people to:

- face the music by recognizing and writing down problem assets,
- borrow money, even though the possible uses for it may seem ill-fated,
- make loans, despite the scarcity of capital and the risk of loss, and
- buy assets that are underpriced, even though prices seem only to go lower.

Interest rate cuts have made borrowing cheaper, and there will be more. Loans to banks will give them money they can turn around and lend. The government’s decision to let Fannie Mae and Freddie Mac make bigger loans should make capital available in the starved housing market. If necessary, a government backstop of the agencies would do even more (but it also would introduce moral hazard). A holiday from capital requirements would allow regulated financial institutions to take writeoffs and clear their balance sheets without having to worry about falling below minimums. They might even try suspending mark-to-market accounting.

The Fed's recent announcement that it will swap Treasury securities for AAA-rated mortgage debt that isn't trading well is such an attempt to stem the deleveraging process. If things go as the Fed hopes, this exchange should:

- take some mortgage paper out of circulation, improving the supply/demand balance and relieving the downward pressure on prices,
- make it more palatable to hold and buy mortgage paper and, especially, for dealers to maintain inventories and make markets in it,
- reduce yields, and thus the cost of money in the economy, and
- give institutions collateral against which they can borrow (and then lend).

The collapse of Bear Stearns, on the other hand, illustrates a few important limitations. Brokers, like other financial institutions, are highly leveraged entities. The nature of their assets makes it impossible for them to repay their liabilities on demand. Thus, none can survive a "run on the bank" stemming from a loss of confidence. As I said in "The Race to the Bottom," they all offer the same product – basically, money – and if confidence declines, nobody will say, "Okay, there's a 5% chance I'll lose my capital, or access to it for a while, but it's worth it because their product is so superior." **Who'll stay despite a decline in confidence? No one. And what financial institution absolutely can't be the subject of a loss of confidence? I'll let you answer that.**

#### Where Will It End?

When I was a kid, there were a lot of cartoons showing men carrying sandwich boards (who remembers what they were?) that said, "The end of the world is at hand." So far, though, they've been wrong. Likewise, people said we had approached the end of the financial system around Black Monday in 1987, and when LTCM melted down in 1998. But we're still here. It seems we muddle through, despite all attempts to screw things up. It's my guess we always will.

It's tempting for worriers like me to consider apocalyptic possibilities. But it's not productive, so I've quit. I can come up with "China Syndrome" theories, but (a) I can't give them a high probability of coming to pass, and (b) there's little I can do. **The things one would do to gird for the demise of the financial system will turn out to be huge mistakes if the outcome is anything else . . . and chances are high that it will be.**

\* \* \*

Fortunately, one of the most valuable lessons of my career came in the early 1970s, when I learned about the three stages of a bull market:

- the first, 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.

Buying during the first stage can be highly profitable, while buying during the last will carry you over the cliff with the rest of the herd.

Relatively few people were eager to buy at the depressed prices of 2002-03. But buying grew in 2004-05 as prices rose and bargains became scarcer, and the pace became fevered in 2006 and the first half of 2007. This trend was captured in the soaring amounts investors committed to U.S. buyout funds:

2002-03	\$ 52 billion
2004-05	200
2006-07	557

This growth in buyout capital was spurred on by high reported IRRs, which in turn were facilitated by dividend recaps and quick flips, themselves a symptom of the increasingly overheated capital market environment. **Had the high IRRs been the result of genuine investment skill or just well-timed risk taking?** So far we've learned a little about who swam naked – that is, for whom it was the latter rather than the former. We'll know for sure when the tide is fully out.

To aid in your consideration of the future, I've formulated the converse of the above, the three stages of a bear market:

- the first, when just a few prudent investors recognize that, despite the prevailing bullishness, things won't always be rosy,
- the second, when most investors recognize things are deteriorating, and
- the third, when everyone's convinced things can only get worse.

Certainly we're well into the second of these three stages. There's been lots of bad news and writeoffs. More and more people recognize the dangers inherent in things like innovation, leverage, derivatives, counterparty risk and mark-to-market accounting. And increasingly the problems seem insolvable.

One of these days, though, we'll reach the third stage, and the herd will give up on there being a solution. And unless the financial world really does end, we're likely to encounter the investment opportunities of a lifetime. **Major bottoms occur when everyone forgets that the tide also comes in. Those are the times we live for.**

March 18, 2008

*Please see the following page for legal information and disclosures*