

Memo to: Oaktree Clients

From: Howard Marks

Re: It Is What It Is

My first exposure to the phrase that serves as the title for this memo came in 1995, a few days before Oaktree opened its doors. My partners and I wracked our brains over whether we'd covered every base. We asked our attorney, Peter Ostroff of Sidley & Austin, if he thought we'd missed anything. Peter's answer was succinct and on target as usual: "It is what it is."

In the March 5 edition of The New York Times, William Safire devoted the Sunday Magazine's "On Language" column to "it is what it is." He mentioned that the first use he could find had been in 1949, and that the phrase had been adopted for movie and song titles in the last few years. I was shocked when I checked Google and found 4.2 million references!

According to Safire, there is no one definitive meaning for the phrase. It can serve as the equivalent of the politician's "no comment." It can be used to express "philosophical resignation over a disappointment." Or it can be "a mild put-down, as if to say, 'That's all you can expect.'" Safire concluded his column with another possible meaning: "*que sera sera*" (what will be will be), which was the title of a hit song by Doris Day when I was ten. But that interpretation suggests a fatalism and inability to affect the outcome that I don't associate with the phrase.

I took Peter's use of the phrase in 1995 – and I'm using it in this memo – to mean something very different: recognition and acceptance of today's givens . . . but not necessarily of the end result. What's past is past and can't be undone. It has led to the circumstances we now face. **All we can do is recognize our circumstances for what they are and make the best decisions we can "given the givens."**

Roots in Philosophy

In the mid-'60s, Wharton students had to have a non-business minor, and I satisfied the requirement by taking five courses in Japanese studies. These surprised me by becoming the highlight of my college career and contributing to my investment philosophy in a major way.

Among the values prized in early Japanese culture was *mujo*. *Mujo* was defined classically for me as recognition of "the turning of the wheel of the law," implying acceptance of the inevitability of change, of rise and fall.

This sense of accepting and "going with" the environment and the changes that take place there – rather than insisting that it stay the same and attempting to impose our will on it – was captured for me in a quotation from Lao-Tzu (I found it in the March letter from Rimrock Capital, which Paul Westhead left Oaktree in 2004 to head):

To be strong you have to be like water: if there are no obstacles, it flows; if there is an obstacle, it stops; if a dam is broken, then it flows further; if a vessel is square, then it has a square form; if a vessel is round, then it has a round form; because it is so soft and flexible, it is the most necessary and the strongest thing.

In other words, *mujō* means cycles will rise and fall, things will come and go, and our environment will change in ways beyond our control. **Thus we must recognize, accept, cope and respond. Isn't that the essence of investing?**

Coping With Cycles

In the world of investing, (as you've heard me say many times) nothing is as dependable as cycles. Fundamentals, psychology, prices and returns will rise and fall, presenting opportunities to make mistakes or to profit from the mistakes of others. They are the givens.

We cannot know how far a trend will go, when it will turn, what will make it turn, or how far things will then go in the opposite direction. But I'm confident that every trend will stop sooner or later. Nothing goes on forever. Trees don't grow to the sky, and neither do many things go to zero and stay there. Success carries within itself the seeds of failure, and failure the seeds of success.

So what can we do about cycles? If we can't know in advance how and when the turns will occur, how can we cope? On this, I am dogmatic: **We may never know where we're going, but we'd better have a good idea where we are.** That is, even if we can't predict the timing and extent of cyclical fluctuations, it's essential that we strive to ascertain where we stand in cyclical terms and act accordingly.

What Can We Know, and How?

Even without knowing where we're going and when, we can deduce lots of valuable information about our investment environment.

First, where do we stand in the economic cycle? Is the economy several years into a recovery that may be due for a rest? Has it leveled out and begun to weaken? Or has it been weak enough long enough that we can reasonably expect recession to give way to recovery?

Second, how have the markets been performing? Have they been weak for years, possibly pushing prices to bargain basement levels? Or have they been so strong that we should suspect (1) the positives have been fully discounted, (2) several years of potential gains have been accelerated into the returns to date, and (3) assets today are "priced for perfection"?

Finally, and often most important, how are people around us behaving? If they're chastened by losses and afraid of the future, there's reason for us to be optimistic. If they're unworried and complacent, that's something we should worry about. In the words of my favorite Buffettism,

“The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.”

Imagine we ran into a visitor from Mars who observed, “I see your economy and markets have been doing well for years. Everyone’s making a ton of money. No one’s expressing worry or a desire to avoid risk. P/E ratios, buyout prices and private equity leverage ratios are all high. Stock buybacks and dividend recaps are adding to leverage and reducing creditworthiness. Conferences on hedge funds and private equity are sold out. Top-performing funds are closed to newcomers and new ones start up every day, fully subscribed. The Greenwich Ferrari dealer has a waiting list a year long.”

Nothing in our favorite Martian’s statements sounds like a prediction. **In fact, he hasn’t said one word about the future.** But there’s a lot of helpful information there. My guess is valuable inferences could be made about what’s likely to happen next. If he can see it, so should we. And having seen it, we should take appropriately cautious action.

And the reverse can also be true (although it’s not something I dwell on most of the time or at what I think is today’s point in the cycle). If that Martian came down and saw nothing but weak recent returns, widespread disillusionment, disinterest in investing and people waiting for the smoke to clear before they’ll commit, we’d probably conclude it’s time for us to step on the gas.

What to Do

There are few fields in which decisions as to strategies and tactics aren’t influenced by what we see in the environment. Our pressure on the gas pedal varies depending on whether the road is empty or crowded. The golfer’s choice of club depends on the wind. Our decision regarding outerwear certainly varies with the weather. Shouldn’t our investment actions be equally affected by the investing climate?

Most people strive to adjust their portfolios based on what they think lies ahead. At the same time, however, most people would admit forward visibility just isn’t that great. That’s why I make the case for responding to the current realities and their implications, as opposed to expecting the future to be made clear.

In November 2004 I wrote a memo entitled “Risk and Return Today.” Its thesis was that in most asset classes, prospective returns were low and risk premiums were skinny. On that basis, I urged investors to act accordingly, hold reasonable expectations and – especially – decline to stretch for higher returns by taking on more risk. The conclusions are just as clear today:

- When high returns are not in prospect, we shouldn’t invest as if they are.
- When safe investments appear unlikely to provide the returns we need, we shouldn’t rush to riskier investments to get them.
- This is especially true when the reward for taking incremental risk is skimpy.

It’s as simple as that. **We can’t expect high returns when the market doesn’t offer them. Prices won’t fall to levels from which high returns can be expected if most investors are**

willing to settle for less. To quote Peter Bernstein, “The market’s not a very accommodating machine; it won’t provide high returns just because you need them.”

My bottom line, as they might say in the self-help books: **Listen to your inner Martian.** What’s going on usually isn’t that big a mystery. An overheated environment doesn’t mean the market’s going down tomorrow, just as an excess of risk aversion doesn’t signal it’s the absolute bottom. But the circumstances should inform our behavior. Simply observing what’s going on around you and acting accordingly should improve your investment results.

And the distinctions needn’t be cut too fine. There can be lots of room for argument between “undervalued” and “fairly valued,” or between “fairly valued” and “overvalued” – that’s where most of the uncertainty lies. But it’s unlikely that disciplined investors will find it hard to choose between overvalued and undervalued. In my opinion, if you’re wracking your brain trying to figure out whether something’s overvalued or fairly valued – that is, whether you should sell or continue to hold – it’s usually pretty clear that it’s not a buy.

What Is Going On Around Us Today?

No one I know thinks investors today are acting out of an excess of caution, and I agree. Investors have forgotten the losses in stocks, corporate bonds and venture capital earlier this decade and consider this a low-risk world (or at least one where risk is clearly worth taking). Mark Cutis of Shinsei Bank sent me his memo entitled, “Market of no fear!” I think that’s an apt description.

There’s no reason to think today’s environment implies high future returns. Whether it’s high P/E ratios, high transaction multiples in buyouts, low bond yields or low capitalization rates on real estate (and certainly all of these are interrelated), few markets appear to offer bargains.

People are reporting big gains from private equity and real estate assets they bought cheap in the past, levered up in accommodating capital markets and sold at very high prices (read: low prospective returns). But fewer people can claim to be buying in on the cheap today.

A great deal of what’s happening is related to a glut of capital for investment in non-mainstream asset classes. With no one interested in buying more high grade bonds at yields near 5% or U.S. stocks with consensus expected returns of 5-7% or so, capital is bypassing those big markets – or perhaps exiting them – and flocking to the smaller alternative markets, raising prices. I understand why people who need 8% or more are looking there for help, but that doesn’t do much for the likelihood they’ll get what they’re after. (More on this later.)

The skinniness of today’s risk premiums can be observed most clearly in the high yield bond market, where prospective returns can be calculated with precision and yield spreads are in the vicinity of historic lows, and in certain real estate markets, where actual cash returns are similarly low. But the difficulty of quantifying prospective returns in public and private equity doesn’t mean the offerings there are any less paltry. And, as Alan Greenspan said, “. . . **history has not dealt kindly with the aftermath of protracted periods of low risk premiums.**”

This is a time for caution, not aggressiveness. For reaping more than sowing. I said it 16 and 34 months ago, and returns in many US markets have been paltry since. **Some alternative investment returns have been quite good, but high realized returns must never be confused with great opportunities to invest more.** High past returns don't imply high future returns; more likely, they've borrowed from the future.

The Poor Man's Guide to Market Assessment

Here's a simple exercise: I have listed below a number of market characteristics. For each pair, check off the one you think is most descriptive of today. And if you find that most of your checkmarks are in the left-hand column, as I do, hold on to your wallet.

Economy:	Vibrant	Sluggish
Outlook:	Positive	Negative
Lenders:	Eager	Reticent
Capital markets:	Loose	Tight
Capital:	Plentiful	Scarce
Terms:	Easy	Restrictive
Interest Rates:	Low	High
Spreads:	Narrow	Wide
Investors:	Optimistic	Pessimistic
	Sanguine	Distressed
	Eager to buy	Uninterested in buying
Asset owners:	Happy to hold	Rushing for the exits
Sellers:	Few	Many
Markets:	Crowded	Starved for attention
Funds:	Hard to gain entry	Open to anyone
	New ones daily	Only the best can raise money
	GPs hold the cards on terms	LPs have bargaining power
Recent performance:	Strong	Weak
Asset prices:	High	Low
Prospective returns:	Low	High
Risk:	High	Low
Popular qualities:	Aggressiveness	Caution and discipline
	Broad reach	Selectivity
The right qualities:	Caution and discipline	Aggressiveness
	Selectivity	Broad reach
Available mistakes:	Buying too much	Buying too little
	Paying up	Walking away
	Taking too much risk	Taking too little risk

An Inefficient Market in Investment Advice

Bruce Karsh and I recently had an opportunity to sit down to lunch with Charlie Munger. As usual, our conversation was most enjoyable, straying over a large number of topics. I think a few of them – plus some comments from Warren Buffett’s latest annual report – can be woven into something of relevance to this memo and of interest to you.

Bruce started off by observing that with practically everyone able to start up a billion dollar hedge fund, and with the leading private equity managers able to raise funds of \$10 to \$15 billion, jobs in those fields are in great demand as the way to get rich quick. It occurred to me that **if large numbers of people are convinced that a given field is sure to give them instant wealth, something must be wrong. That’s a “bubble expectation.”** Getting rich – if it can be accomplished at all – is supposed to come from some combination of proven skill, hard work, risk bearing and luck. No one should be able to count on it, and especially not in the short run. And given the operation of market forces, such an opportunity shouldn’t last long.

Then I remembered that for decades I’ve argued that exceptional risk-adjusted returns can only be achieved in inefficient markets, and even then not all the time or by everyone. And by “inefficient markets,” I’ve always meant markets where mistakes are being made. **So if large numbers of alternative investment managers and would-be managers are planning on getting rich quick, the investment management market must be inefficient: they and/or someone else must be making a mistake.** Who else could it be? **Maybe it’s their clients.**

Today, as everyone knows, funds can be raised easily and at sizes no one imagined just three years ago. But assets are no longer as cheap as they used to be, interest rates are no longer as low, and the economic recovery isn’t as young. I recently heard a speech in which a top buyout manager said his fund’s goal (per my memory) is to buy companies at fair prices and make them worth more. In the past, he might’ve said they tried to buy companies cheap.

On the plus side of the ledger for private equity, managers think more like owners than do many public company boards; are substantially incentivized to see the funds’ assets appreciate; and have the potential to improve their previously undermanaged companies. On the negative side, however, the three of us noted that clients are currently entrusting record amounts of money to these managers, along with management fees big enough to allow the managers to get rich without making successful investments, as well as a share in transaction fees that have the potential to put the interests of fund managers and their clients in conflict.

I believe the investors in these funds feel they’ll be happy if they can earn net returns in the very low double digits. The modest nature of their aspirations stems from the juxtaposition of (a) the perceived inadequacy (mentioned earlier) of the prospective returns on mainstream stocks and bonds, (b) the large sums some institutions have to invest, and (c) the 8%-or-better returns that pension funds and endowments must achieve if they are to continue business as usual. This combination makes it imperative that they commit to alternative investments and hedge funds, and thus tilts the balance of bargaining power over fees to the fund managers. This, in turn, decreases the likelihood that terms will be designed to maximize the clients’ interests. It also can give the managers amounts of capital that pose a problem.

In his letter discussing Berkshire Hathaway's 2005 performance, Warren Buffett tells the priceless story of the Gotrocks family, which owns all the corporations in America and earns all the profits. Over time, individual family members are approached by broker-Helpers, manager-Helpers and consultant-Helpers, who promise to help them make money (for a fee) by buying certain pieces of the empire from their relatives and selling them others. Eventually they also hook up with hyper-Helpers, wearing uniforms saying "Private Equity" and "Hedge Fund," who levy success fees on top of their other charges. It's clear that the collective efforts of all the Helpers in shuffling assets among Gotrocks family members are unlikely to increase the family's overall wealth (just as is true when companies are sold from one private equity fund to another). At the same time, whether they're successful or not, the costs involved in trying will cause a substantial transfer of wealth from the Gotrocks to their "Helpers." But that's the way it is.

In April 1998 I observed in "Views on Alternative Investments" that some good performing managers might choose to "appropriate for themselves a bigger portion of their funds' superior returns." This is natural and happens in all businesses where the product is in strong demand. But that doesn't mean buyers should ignore it when it occurs.

I'm not saying alternative investments and hedge funds won't provide the returns clients need, or that people shouldn't invest in them. But realistically assessing the demand for these funds, the amounts of money going into them, the market conditions for the underlying asset classes and the deals the managers are able to cut for themselves might cause would-be investors to conclude the silver bullet still hasn't been invented. **Participate in alternative investments if you want – in fact, Oaktree hopes you'll keep doing so – but do it with your eyes open.**

Charlie ended the lunch by urging us to create reasonable expectations among our clients and treat them well. We promised to try.

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None of us can individually influence economic or market conditions. Neither, I think, can we accurately see what lies ahead. **But it's possible to derive inferences from the recent past and the present that improve our judgments and actions regarding the future. It's simply essential that we be aware of what's going on around us.** After all, who can argue with the statement "it is what it is"?

Facing up to reality is what Warren Buffett's doing when he says "We used to find it easy to buy dollars for fifty cents. Today we're trying hard to find dollars we can buy for eighty cents." (He also told me he has an 800 number for anyone who knows where 80-cent dollars can be found.) **Recognizing and accepting these things when they're true isn't pleasant, but there is no prudent alternative.**

Oaktree tries hard to take note of prevailing market conditions, communicate what's going on and behave as contrarians. We try to raise bigger funds and buy more aggressively when we think others are leaving bargains on the table and do the opposite when they're not. It doesn't always work, but it usually beats the alternative.

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