Memo to: Oaktree Clients

From: Howard Marks

Re: We're Not In 1999 Anymore, Toto

In "The Wizard of Oz," a tornado carried Dorothy and her dog, Toto, to a land ruled by a mysterious despot in whom people had vested extraordinary powers. In the investment world of 1999, similarly, the promise of easy money powered a wild ride into a world in thrall to high tech investing. Both of these seemingly omnipotent forces were eventually exposed as vulnerable, however, and the spells surrounding Oz and the stock market were broken.

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In my favorite commercial of 1999, Stuart, the cyber-geek from the mailroom, exhorted his boss to make his first on-line stock purchase, saying, "Let's light this candle!" When Mr. P. protested that he didn't know anything about the stock, Stuart suggested, "Research it." Mr. P. pushed a button on his keyboard and a few seconds later, suddenly wiser, proceeded to buy his first hundred shares. Like many, he demonstrated how easy it is to feel smart in a bull market.

In 2000, on the other hand, on-line brokerage commercials were different. When the little boy asked his father what he was doing at the computer, the father said he was investing for his college education. Looking over his dad's shoulder, the boy was curious about the on-screen data. "Five-year earnings, p/e ratio . . ." the father enumerated. "A p/e ratio of 23," the son asked, "is that good?" The father's dumbfounded silence clearly reflected his sudden realization that he knew less than he had thought.

Obviously, in 2000, millions of investors across the board realized that they knew less than they thought they did, and that lots of what they had been sure of was wrong.

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A year ago, I wrote in "bubble. com" that tech stocks had benefited in 1999 from a boom of colossal proportions. They exhibited all of the elements of a market bubble, with an attractive story providing the foundation for a gravity-defying escalation of prices far beyond reason, and for manic behavior on the part of investors. I urged readers to view the tech stocks skeptically, but I also acknowledged that it's possible for overpriced assets to remain so for a long time. **I certainly had no idea that the excesses I saw in the market would be remedied as quickly as they have.**

The Bubble Bursts

In every regard enumerated in "bubble. com" and more, the tech-media-telecom extremes of 1999 were reversed in 2000. I must say I've never seen anything quite like it.

Business models questioned – A year ago, I went to great lengths criticizing dot-com business models that valued eyeballs over profits and viewed operating losses as a good investment. This year, investors realized that the emperor was naked. The first signs came in articles like "Burning Up" (Barron's, March 20), which cited the rate at which Internet companies were using their finite cash to fund operating losses. More recently, "The Giveaway Is Going Away On Web Sites" (Wall Street Journal, December 4) stated that "many of the online companies that are in a sad state today can blame their woes on the cornucopia of free stuff and services they have been doling out to build market share." So now it's "p-to-p," or path-to-profit . . . just a little late. Technology entrepreneurs went through their cash, secure in the expectation that they could always raise more by selling shares to eager buyers. In today's market, as the British say, that's simply not on.

Technology firms disrespected – Prospective investors (not to mention bankers, suppliers and landlords) now want to see profit potential. The laws of business are being enforced, meaning that money-losing companies can't attract additional capital. Scores of firms have closed, and tens of thousands of employees have lost their jobs. In perhaps the height of indignity, the Internet has been turned against its own, as dot-coms have been formed to chronicle the collapse of dot-coms. Log on to dotcomfailures.com for a list of more than eighty.

Tech/media/telecom stocks brought low – Of course, the stocks that soared in 1999 tanked in 2000. The 86% gain of the **NASDAQ** Composite in 1999 was the greatest in history for any major average. Its 39% loss in 2000 was the greatest in its history and, in terms of major averages, trailed only the 1931 drops in the Dow and S&P.

Throughout my 30-plus years in the investment business, I have seen one localized boom after another. Each time, the end was marked by a Wall Street Journal table cataloging once-hot stocks that had fallen more than 90% from their highs. Conglomerates (late 1960s), computer software and services (1969-70), the Nifty-Fifty (1973-4), oil stocks (early '80s) and biotech (early '90s) – they've all been there, and I felt certain that TMT stocks would join them sooner or later. The only difference is that in 2000, the top ten losers on the NASDAQ all declined **more than 99%!**

The 14 stocks mentioned a year ago in "bubble.com" provide a pretty good sample; they're down 82% on average from their year-end 1999 prices and 87% from their highs in 2000. Eight of the fourteen are down 96% or more from the top (see the table on the last page for the details).

IPOs no longer a sure thing – If you ask me, the most important single contributor to the tech stock bubble was the mania for Initial Public Offerings. When new issues began to double, triple and more on their first day of trading - and then triple again from there - a gold rush started. When the stock market valued profitless new ventures, only months after their formation, at multiples of their sales (and, illogically, at multiples of the price at which founders were gladly to sell), anything was possible. The lottery was on, and the improbable but huge payoffs going to the winners made every ticket valuable. Later, investors ignored the odds against success and acted as if all of the companies - even head-to-head competitors-would be winners. The perpetual motion machine eventually lost its momentum, of course, and it turned out that there's no sure thing. Although the IPOs of 2000 averaged a first-day gain of 55%, about two-thirds of them are now trading below their issue price.

Venture capital rendered mortal – 1999 witnessed the wildest single market phenomenon I've ever seen: an asset class with a triple-digit annual return. The overheated IPO market provided an exit for the venture capitalists and contributed greatly to their fabulous profits. The model was simple: create a business plan (on the proverbial napkin), raise a little money, staff up and open the doors, spend wildly to build demand for products sold at a loss and go public at a hundred - or a thousand - times invested cost. In contrast to last year's banner headlines, 2000's venture capital stories are a little murkier. How did the funds do in 2000? Given the vagaries of pricing and the lags in reporting, no one has a good reading on performance yet.

I want to highlight one thing, though: venture capital funds often distribute shares to investors and reckon the amount distributed based on the market price of the stock at the time. But if investors don't realize that price, their actual returns may be far lower than those claimed by the funds. If the subsequent declines are charged to the investors' public stock portfolios, we may never know what venture capital returns really were.

Analysts defrocked – I think one of the usual hallmarks of a market mania is personification. This time around, the heroes included brokerage firm analysts like Mary Meeker and Henry Blodget, who were lionized in Internet chat rooms and whose target prices for stocks were given great credence by investors. It turns out, though, that many analysts weren't basing their targets on analytically-derived profit and p/e estimates but, in a stunning circularity, on what they thought investors might pay. It's now clear the analysts added little insight in terms of either fundamentals or valuation.

The December **18** Wall Street Journal revisited six price targets. On average, the analysts predicted a **64%** gain, but the stocks declined **88%** instead. For me, the most telling thing was one analyst's alibi: "By setting [the target] only about 25% higher. . . we were indicating there was only a little more upside in the stock." I seem to remember when calling for a 25% gain was a bullish statement, not a warning. But then again, all kinds of nutty behavior typified this bubble.

Odds and ends at the extreme - Numerous other elements, large and small, captured the excesses of the tech stock mania and their reversal.

- In 1999, incubators (CMGI and Internet Capital Group), technology industry participants (Intel and Amazon) and outsiders (Starbucks) were piling up profits in venture investments. This year, of course, it was losses that fell to the bottom line.
- The potential for stock option profits made dot-com jobs compellingly attractive last year, and old economy firms had no way to compete. This year, employees wanted cash instead, and what we read about is the negative effect of stock options on companies' finances.
- Last year, the media told of executives jumping from the old economy to dot-coms. This year's stories described surprise firings and careers left in the lurch.
- In 1999, brokerage house Internet conferences drew big crowds. 2000 saw conferences postponed and cancelled.
- Whereas tech stocks commonly reached triple-digit prices in 1999, now they're falling below $1 and being delisted by NASDAQ.
- Instead of experiencing dramatic capital inflows and perhaps closing to new investors, tech and Internet mutual funds are diversifying into other areas, merging with other funds or shutting down.
- Finally, in the most visible indicator, we'll see on January 28 that dot-coms will run only about 10% of the commercials during the Superbowl, down from 50% last year.

Of course, the bottom line is that lots of things people considered eminently logical in 1999 – like low-risk triple-digit gains – are now being shown to have been far too good to be true. The headlines of 1999 look silly now, and the debunking in 2000 seems obvious (e.g., "What Are Tech Stocks Worth, Now That We Know It Isn't Infinity?" in the Wall Street Journal on April 17). But that's a juxtaposition that marks the end of every market boom.

<u>How'd We Get Here?</u>

In the 1990s, positive macro forces contributed to an extremely benign environment and steadily reinforced each other:

- low inflation,
- the shift of the federal budget from deficit to surplus,
- easy money at low interest rates,
- technological gains, and
- a high degree of risk tolerance.

These things gave rise, in turn, to the elements of economic and investor prosperity:

- strong corporate and individual borrowing, leading to leveraged balance sheets,
- aggressive buying by businesses, consumers and investors,
- massive gains in productivity,

- unusually rapid growth in corporate profits, and
- strong appreciation in asset prices.

Now, with some of the props removed or in question, we are seeing:

- retail and auto sales down,
- consumer and investor confidence off,
- factory orders falling and layoffs on the rise,
- profit warnings everywhere,
- risk aversion that has reasserted itself (or should we call it fear?),
- rising defaults, bankruptcies and troubled bank loans, and
- significantly lower stock and corporate bond prices.

All of this is normal cyclical behavior. Cycles are one of the few things we can rely on, as you have heard me say repeatedly, and this downswing is moving along familiar lines. What surprised even me this time around is the rapidity and severity of these developments. Given the extreme nature of the ascent, though, I guess an equally extreme reversal is not unreasonable.

Of course, former bulls will say this downturn was initiated/accelerated/exacerbated by unforeseen developments that blindsided them: skyrocketing prices for oil, gas and electric power; rising tensions in the Middle East; and the bizarre post-election chaos. But the important point is that something eventually derails every Pollyanna scenario. In 1998, I criticized the oxymoronic attitude exemplified by "we're not expecting any surprises." Somehow, surprises always seem to occur. Expectations (and stock prices) that assume there won't be any are dashed sooner or later, and optimism turns to disappointment.

I date this cycle's turning point in investor psychology to the third quarter of 1998, with the Russian default and the collapse of Long-Term Capital Management. Before that, investors seemed to consider risk their friend. They blithely interpreted the upward-sloping path of the Capital Market Line to mean that bearing more risk would reliably bring more return. (For example, one consultant told me his firm wouldn't recommend Oaktree's high yield bond management because they "wanted to maximize risk" and knew they couldn't accomplish that with us.) But the Russia and Long-Term fiascoes popped that balloon and reminded participants that risk-taking isn't always profitable.

Here's an illustration of the impact of these events on psychology. According to CSFB, from the end of 1996 to the middle of 1998, the face amount of "distressed" bonds yielding more than 20% (and thus indicating grave concern over credit) grew just $6 billion per year on average. But in the 2-1/3 years following Russia and Long-Term, from mid-l998 through October 31, 2000, the amount increased by an average of $38 billion per year. Actual defaults grew only half as much over that period, ($18 billion per year), but investors' sharply reduced willingness to bear risk caused the distressed bond count to explode upward.

(If I'm right in saying risk tolerance turned to risk aversion in 1998, you might ask how the tech/media/telecom boom could have continued into 1999 and early 2000. The answer: it's the exception that proves the rule. Even as investors were turning more conservative and capital was being withdrawn from hedge funds and banks' and brokers' proprietary portfolios, the crowd took to TMT investing in a way that ignited the IPO boom and everything that followed. It's often said that at the end of a bull market the vast majority of stocks weaken while one popular sector goes on to a highly extended extreme before collapsing. Certainly that's what happened in 1999, when the tech-dominated NASDAQ rose 86% at the same time that the S&P 500 excluding technology was up only ***3%*** (Wall Street Journal, December 21).

In 2000, the last holdouts – the TMT aficionados – finally realized that they had overstated their companies' potential, ignored their dependence on a benign environment, understated the danger implied by the market's manic volatility and paid too much for their stocks. All of the positives of 1999 turned into negatives, with catastrophic results.

The declines in the TMT stocks in 2000 provide a tangible reminder that psychology can change much faster than fundamentals. A little fundamental deterioration, when mixed with increased pessimism, can wreak absolute havoc with asset prices.

Now What?

I see little chance that the boom-creating factors enumerated above – the hallmarks of the 1990s – will characterize the next few years. In particular, I see higher risk aversion and tighter credit. But, of course, the prices of many stocks and bonds in the tech sector have undergone serious corrections. So the question to ask is "Have they fallen enough?"

The answer is simple: I don't know. Nokia is down 55% from its high but still trades at 61 times earnings (New York Times, December 2l). Qualcomm fell 53% but is still at 65 times expected earnings (Los Angeles Times, December 31). Overall, the NASDAQ Composite, which includes many profitless companies, is valued at 90 times its companies' total earnings (Wall Street Journal, December 20).

No one can know which way a market's going to go, but a few eternal truths and the right mindset – the significance of which has been reinforced by the experience of the last few years – can best prepare us to handle the inevitable uncertainty.

Beware of generalizations – Most of the time, and especially at the extremes, markets over-generalize. Last year, investors acted as if all of the telecom companies would succeed; this year, investors seem to think they're all losers. In 1996 and 1997, financial institutions would lend to anyone; now, even strong companies have trouble getting capital. When the market "throws the baby out with the bathwater," as we believe it's doing now, gems can often be found among the wreckage. As a result, for example, our Distressed Debt and Principal groups are prospecting for overlooked values in telecom. Also flawed are many of the broad rules that investors invoke. In 1999, no cry was heard more often than "buy the dips." Each time the market dropped a bit, buyers stepped in.

Anyone who bought in those declines benefited from the rallies that surely followed. Of course, that didn't work quite so well in 2000. The dips in March-April, May and July were all followed by rallies, but they were traps for unsuspecting buyers. Only "sell the rallies" proved correct.

Respect cycles – There's little I'm certain of, but these things are true: Cycles always prevail eventually. Nothing goes in one direction forever. Trees don't grow to the sky. Few things go to zero.

That was really the problem with the bubble. Investors were willing to pay prices that assumed success forever. They ignored the economic cycle, the credit cycle and, most importantly, the corporate life cycle. They forgot that profitability will bring imitation and competition, which will cut into – or eliminate – profitability. They overlooked the fact that the same powerful force that made their companies attractive, technological progress, could at some point render them obsolete.

Worry about time – Another element that investors ignore in their optimism is time. It seems obvious, but long-term trends need time in order to work out, and time can be limited. Or as John Maynard Keynes put it, "Markets can remain irrational longer than you can remain solvent." Whenever you're tempted to bet everything on a long-run phenomenon, remember the six-foot tall man who drowned crossing the stream that was five feet deep on average.

One of the great delusions suffered in the 1990s was that "stocks always outperform." I agree that stocks can be counted on to beat bonds, cash and inflation, as Wharton's Prof. Jeremy Siegel demonstrated, but only with the qualification "in the long run." If you have thirty years, you can rest assured that equity returns will be superior. For someone with a thirty-year time frame, the decline of the NASDAQ in 2000 may have been a matter of indifference. But it didn't feel that way to most people.

Time came into play in another way for the TMT entrepreneurs. Many raised the money they needed for a year or two and proceeded to burn it up. They counted on being able to raise more later, but in 2000 capital was denied even to worthwhile ideas. Lots of companies never got the chance to reach profitability. More important than money, they ran out of time.

Remember that, for the most part, things don't change – The five most dangerous words in our business aren't "The check's in the mail" but "This time it'll be different." Most bubbles proceed from the belief that something has changed permanently. It may be a technological advance, a shortage or a new fad, but what all three have in common is that they're usually short-lived.

Most "new paradigms" turn out to be just a new twist on an old theme. No technological development is so significant that its companies' stocks can be bought regardless of price. Most shortages – whether of commodities or securities – ease when supply inevitably rises to meet demand. And no fad lasts forever.

<u>Never forget valuation</u> – The focus may shift from dividend yield to p/e ratio, and people may stop looking at book value, but that doesn't mean valuation is irrelevant. In the tech bubble, buyers didn't worry about whether a stock was priced too high because they were sure someone else would be willing to pay them more for it. Unfortunately, the "greater fool theory" only works until it doesn't. Valuation eventually comes into play, and those who are holding the bag when it does are forced to face the music.

<u>Be conscious of investor psychology</u> – I don't believe in the ability of forecasts or forecasters to tell us where prices are going, but I think an understanding of investor psychology can give us a hint. When investors are exuberant, as they were in 1999 and early 2000, it's dangerous. When the man on the street thinks stocks are a great idea and sure to produce profits, I'd watch out. When attitudes of this sort make for stock prices that assume the best and incorporate no fear, it's a formula for disaster.

I find myself using one quote, from Warren Buffett, more often than any other: "The less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs." When others are euphoric, that puts us in danger. When others are terrified, the prices they set are low, and we can be aggressive. On December 22, in "Consumer Mood Swings to Angst," the New York Times employed a new phrase: "irrational anxiety." If that sentiment does come to be widespread, replacing irrational exuberance, it can signal a buying opportunity.

<u>Check your own mindset</u> – For me, mindset holds many of the keys to success. We at Oaktree believe strongly in **contrarianism**. As suggested in the paragraph above, that means leaning away from the direction chosen by most others. Sell when they're euphoric, and buy when they're afraid. Sell what they love, and buy what they hate.

Closely related to contrarianism is **skepticism**. It's a simple concept, but it has great potential for keeping us out of trouble. If it sounds too good to be true, it probably is. That phrase is always heard <u>after</u> the losses have piled up – be it in dot-coms, portfolio insurance, "market neutral" funds or the "Asian miracle." Oaktree was founded on the conviction that free lunches do exist, but not for everyone, or where everyone's looking, or without hard work and superior skill. Skepticism needn't make you give up on superior risk-adjusted returns, but it should make you ask tough questions about the ease of accessing them.

We think **humility** is essential, especially concerning the ability to know the future. Before we act on a forecast, we ask if there's good reason to think we're more right than the consensus view already embodied in prices. As to macro projections, we never assume we're superior. About under-researched companies and securities, we think it's possible to get an edge through hard work and skill.

Finally, we believe in **investing defensively**. That means worrying about what we may not know, about what can go wrong, and about losing money. If you're worried, you'll tend to build in more margin for error. Worriers make less when everything goes right, as in the tech bubble, but they also lose less – and stay in the game – when things return to earth. At Oaktree, we're guided more by one principle than any other: **if we avoid the losers, the winners will take care of themselves.**

These are the things that Oaktree is built on, and that got our clients through 2000 in one piece. We can't promise that all of our investment decisions will be correct, but we can assure you they will embody these crucial ingredients for success in 2001 and beyond.

December 31, 2000

Stocks Mentioned In "bubble.com" – January 1, 2000

Company	**Ticker Symbol**	**Price 12/31/99**	**2000 High**	**Price 12/31/00**	**% Chng. 12/31/99 to 12/31/00**	**% Chng. 2000 high to 12/31/00**
Akamai Tech.	AKAM	$328	$346	$ 21	-94%	-94%
Amazon.com	AMZN	76	92	16	-80	-83
America Online	AOL	76	83	35	-54	-58
Charles Schwab	SCH	26	45	28	+11	-37
CMGI	CMGI	138	164	6	-96	-97
E*Trade	EGRP	26	33	7	-72	-78
Egreetings Network	EGRT	10	13	#	-97	-98
Etoys	ETYS	26	28	#	-99	-99
Priceline.com	PCLN	47	104	1	-97	-99
Red Hat	RHAT	106	148	6	-94	-96
Theglobe.com	TGLO	8	10	#	-96	-97
VA Linux Sys	LNUX	207	208	8	-96	-96
Webvan	WBVN	17	19	#	-97	-97
Yahoo!	YHOO	216	250	30	-86	-88
Average					-82%	-87%

= below 50¢