Memo to: Oaktree Clients

From: Howard Marks

Re: The Realist's Creed

Early this year, I was asked to write an article for "Trusts & Estates" magazine. Here it is, in part cobbled together from things I've written in the past, and slightly changed from the version that was published in April.

The editors wanted me to recommend a course of investment action for beneficiaries and their fiduciaries. To most people that means deciding how much to put into stocks and bonds (and which ones), and whether private equity and hedge funds should be included. It usually sounds easy: all you have to do is make a few simple judgments about the future. I decided to write a very different article: it's going to tell you how hard investing is, and how you can best equip yourself for the task.

First, I think investing must be based on a firmly held belief system. What do you believe in, and what do you reject? Put another way, what are the principles that will guide you?

For me, the starting point consists of deciding which approach to take in dealing with the future. That decision primarily revolves around choosing between two polar opposites: what I call the "I know" school and the "I don't know" school.

Most of the investment professionals I've met over my 33 years in the industry fall squarely into the "I know" school. These are people who believe they can discern what the future holds, and in their world investing is a simple matter:

- First you decide what the economy is going to do in the period under consideration.
- Then you figure out what the impact will be on interest rates.
- From this you infer how the securities markets will perform.
- You choose the industries that will do best in that environment.
- You make judgments about how the industries' companies will fare in terms of profits.
- Based on all of this information, you pick stocks that are bound to appreciate.

End of story. Of course, the usefulness of this approach depends entirely on people's ability to make these decisions correctly. What if you're wrong about the economy? What if you're right about the economy but wrong about its impact on a company's profits? Or what if you're right about profits but the valuation parameters contract, and thus the price? The bottom line is that the members of this school think these things are knowable. I know lots of people who are perpetually and constitutionally optimistic about both the long-term future for stocks and their ability to make these judgments correctly.

On the other hand, I and most of the investors with whom I feel an affinity belong to the "I don't know" school. In short, (1) we feel it's impossible for anyone to know much about a vast number of things, (2) we consider it especially difficult to outperform by guessing right about the direction of the economy and the markets, (3) we spend our time trying to know more than the next person about specific micro situations, and (4) we think more about what can go wrong than about what can go right. In contrast to the "I know" school, people in this group are more cautious and feel a strong need for downside protection.

Sticking to this approach requires some solid building blocks. One of those is **contrarianism**. Basically 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. In general, I think you'll find few bargains among the investments that everyone knows about, understands, feels comfortable with, is impressed by and is eager to own. Instead, the best bargains usually lie among the things people aren't aware of, don't fully understand, or consider arcane, unseemly or risky.

Closely related to contrarianism is **skepticism**. It's a simple concept, but it has great potential for keeping investors out of trouble: **If it sounds too good to be true, it probably is**. That phrase is always heard after the losses have piled up – be it in portfolio insurance, "market neutral" funds, dot-coms, or Enron. My career in money management has been based 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.

Thus I also advocate **modest expectations**. To shoot for top-quartile performance every year, you have to hold an idiosyncratic portfolio that exposes you to the risk of being outside the pack and dead wrong. It's behavior like that that leads to managers being carried off the field when things go poorly – and to clients losing lots of money. It's far more reasonable just to try for performance that's consistently a little above average. Even that's not easy to achieve, but if accomplished for a long period it will result in an outstanding track record.

I think **humility** is essential, especially concerning the ability to know the future. Before acting on a forecast, we must ask whether there's good reason to think we're more right than the consensus view already embodied in prices. I think it's possible to get a knowledge advantage with regard to under-researched companies and securities, but only through hard work and skill.

Finally, I'm a strong believer in **investing defensively**. That means worrying about what one may not know, about what can go wrong, and about losing money. If you're worried, you'll tend to build in greater margin for error. Worriers gain less when everything goes right, but they also lose less – and stay in the game – when things return to earth. All of Oaktree' s activities are guided more by one principle than any other: **if we avoid the losers, the winners will take care of themselves**. We're much more concerned about participating in a loser than we are about letting a winner get away. In my experience, long-term investment success can be built much more reliably on the avoidance of significant losses than it can on the quest for outsized gains. A high batting average, not a swing-for-the-fences style, offers the most dependable route to success.

<u>Second</u>, I'd advise you to approach the entire subject of forecasts and forecasters with extreme distrust. Reduced to the absolute minimum, investing consists of just one thing:

Making judgments about the future. And the future is inherently uncertain. Everyone looks for help in dealing with this uncertainty, and their usual recourse is to put faith in forecasters. How could they not? Most forecasters are highly articulate, represent prestigious institutions, and exude total confidence in their knowledge of the future.

The problem, however, is that they're not often right, or at least not consistently more right than others. And almost never do they (or anyone else) record and assess their accuracy over time. Here's the way I view the forecasting game.

- There are hundreds, or more likely thousands, of people out there trying to predict the future, but no one has a record much better than anyone else. **Given how valuable superior forecasts can be, recipients should wonder why anyone who was capable of consistently making them would distribute them gratis**.

- Market prices for assets already incorporate the views of the consensus of forecasters. Thus holding a consensus view, even if it's right, can't help you make above-average returns.

- Non-consensus views can make you a lot of money, but to do so they must be right. Because the consensus reflects the forecasting efforts of a large number of intelligent and informed people, however, it's usually the closest we can get to right. In other words, I doubt there's anyone out there with non-consensus views that are right routinely.

- Most of the time, the consensus forecast extrapolates current observations. Predictions for a given parameter usually bear a strong resemblance to the level of the parameter prevailing at the time they're made. Thus predictions are often close to right when nothing changes radically, which is the case most of the time, but they can't be counted on to foretell the important sea changes. And as my friend Ric Kayne says, "everything important in financial history has taken place outside of two standard deviations." It's in predicting radical change that extraordinary profit potential exists. In other words, **it's the <u>surprises</u> that have profound market impact (and thus profound profit potential), but there's a good reason why they're called surprises: it's hard to see them coming!**

- Each time a radical change occurs, there's someone who predicted it, and that person gets to enjoy his fifteen minutes of fame. Usually, however, he wasn't right because of a superior ability to see the future, but rather because he regularly holds extreme positions (or perhaps he's a dart thrower) and this time the phenomenon went his way. Rarely if ever is that person right twice in a row.

So forecasts are unlikely to help us gain an advantage, but that doesn't make people stop putting their faith in them. It's unsettling to realize how much in the dark we investors are concerning future developments. But there's one thing worse: to ignore the limits of our foresight. The late Stanford behaviorist Amos Tversky put it best: **"It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on."**

<u>Third</u>, I think it's essential to remember that just about everything is cyclical. 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. **And there's little that's as dangerous for investor health as insistence on extrapolating today's events into the future.**

The economy will not rise forever. Industrial trends won't continue indefinitely. The companies that succeed for a while often will cease to do so. Company profits won't increase without limitation. Investor psychology won't go in one direction forever, and thus neither will security prices. An investment style that does best (or worst) in one period is unlikely to do so again in the next.

That was really the problem with the technology 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 would bring imitation and competition, which would 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. And they failed to consider that the investing fads in favor of these technologies, companies and stocks could reverse, with dire consequences.

<u>Fourth</u>, investors should bear in mind the role played by timeframe. 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 heavily on your conviction that a given phenomenon can be depended on in the long run, think about 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, it's reasonable to expect equity returns to be superior to those on bonds. For someone with a thirty-year timeframe, the NASDAQ's decline since 2000 may turn out to be a matter of indifference. But it hasn't felt that way to the people holding the stocks.

The need for time came into play in another way for the technology and telecommunications 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 2000-02 capital has been denied even to worthwhile ideas. Lots of companies never got the chance to reach profitability. They simply ran out of time.

Fifth, you must never forget the key role played by valuation. Investment success doesn't come primarily from "buying good things," but rather from "buying things well" (and the difference isn't just grammatical). **It's easy for most people to tell the difference between a good company and a bad one, but much harder for them to understand the difference between a cheap stock and an expensive one**. Some of the biggest losses occur when people buy the stocks of great companies at too-high prices. In contrast, investing in terrible companies can produce huge profits if it's done at the right price. Over time, investors may shift their focus from dividend yield to p/e ratio, and they may stop looking at book value, but that doesn't mean valuation can be considered 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, this "greater fool theory" only works until it doesn't. They also thought the technological developments were so great that the companies' stocks could be bought regardless of price. In the end, though, when newness becomes old, flaws appear and investor ardor cools, the only thing that matters is the stock's price . . . and it's usually much lower.

Most shortages – whether of commodities or securities – ease when high prices inevitably cause supply to rise and satisfy the demand. And no fad lasts forever. Thus valuation eventually comes into play, and those who are holding the bag when it does are forced to face the music.

Sixth, beware the quest for the simple solution. Two important forces drive the search for investment options: the urge to make money and the desire for help in negotiating the uncertain future. When a market, an individual or an investment technique produces impressive returns for a while, it generally attracts excessive (and unquestioning) devotion. I call this solution-du-jour the "silver bullet."

Investors are always looking for it. Call it the Holy Grail or the free lunch, but everyone wants a ticket to riches without risk. **Few people question whether it can exist, or why it should be available to them**. At the bottom line, hope springs eternal. Thus investors pursued Nifty-Fifty growth stock investing in the 1970s, portfolio insurance in the '80s, and the technology boom of the '90s. They aligned themselves with "geniuses" they thought would make investing easy – be it Joe Granville, Elaine Garzarelli or Henry Blodgett.

But the silver bullet doesn't exist. No strategy can produce high rates of return without risk. And nobody has all the answers; we're all just human. **Markets are highly dynamic and, among other things, they function over time to take away the**

opportunity for unusual profits. Unskeptical belief that the silver bullet is at hand eventually leads to capital punishment.

<u>Seventh</u>, you must be aware of what's going on around you in terms of investor psychology. I don't believe in the ability of forecasters to tell us where prices are going, but an understanding of where we are in terms 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 frightened and pull back, their behavior makes bargains plentiful. In other words, what others are thinking and doing holds substantial ramifications for you. And that brings us full circle to the importance of contrarianism.

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I've cataloged above the "mental arsenal" I feel is needed in the battle for investment success. I'll proceed below to illustrate the application of some of these concepts to two key asset classes: **common stocks**, the grand-daddy of all active investments, and **hedge funds**, a much smaller area that is in the process of attracting a lot of attention (and capital).

<u>Common stocks</u> – Among the mantras that were repeated in the past decade, few received as much credence as "stocks outperform." Wharton's Professor Jeremy Siegel documented in his book, "Stocks for the Long Run," that equities have beaten bonds, cash and inflation over almost all long periods of time. In fact, his graph of the movements of the stock market since 1800 looks like a straight line rising from lower left to upper right. Evidence like this allowed people to invest heavily in the stock market while continuing to sleep well. Little did they know that the price gains that made them feel so sanguine about their positions were dramatically increasing their risk.

I am a great believer in common stock investing, but I hold tight to a few caveats:

- Return expectations must be reasonable.
- The ride won't be without bumps.
- It's not easy to get above-market returns.

We live in the world's most productive economy, under a very effective capitalist system, at a wonderful point in time. In general, it's great to own productive assets like companies and their shares. **But occasionally, people lose track of the fact that in the long run, shares can't do much better than the companies that issue them**. Or to paraphrase Warren Buffett, when people forget that corporate profits grow at 8 or 9% per year, they tend to get into trouble.

It's never clear what base period makes for a relevant comparison, but between 1930 and 1990, annual returns from stocks averaged about 10% year. Periods when they did better were followed by periods when they did worse. The better periods were usually caused by the expansion of p/e ratios, but valuations tended to return from the stratosphere, and in the long run, returns roughly paralleled profit growth.

There always will be bull markets and bear markets. The bull markets will be welcomed warmly and unskeptically, because people will be making money. These markets will be propelled to great heights, usually by the rationalization that "it's different this time"; that productivity, technology, globalization, lower taxation – something – has permanently elevated the prospective return from stocks.

The bear markets will come as a shock to the unsuspecting, demonstrating that, most of the time, the world doesn't change that much. For example, when you look at Siegel's 200-year straight-line stock market graph, no hiccup is visible in 1973-74. Try telling that to the average equity investor, who lost half his money.

The bottom line is that risk of fluctuation always is present. Thus stocks are risky unless your time frame truly allows you to live through the downs while awaiting the ups. Remember what Lord Keynes said about the ability of markets to remain irrational for long periods of time. And remember that it's possible for you to be forced to sell at the bottom – by emotions, competitive pressure or the need for liquidity – turning temporary volatility (the theoretical definition of risk) into very real permanent loss.

In order to get more out of the ups of stocks and try to lessen the pain of the downs, most people turn to active management via market timing, group rotation, industry emphasis and stock selection. But it's just not that easy. The American Way – earnestly applying elbow grease – doesn't often payoff. **For a model, don't think about the diligent paperboy on his route; think about trying to profit from flipping a coin**.

I say that because I believe most markets are relatively "efficient," and that certainly includes the mainstream stock market. Where large numbers of investors are aware of an asset's existence, have roughly equal access to information and are diligently working to evaluate it, the market operates to incorporate their collective interpretation of the information into a market price. While that price is often wrong, very few investors are capable of consistently knowing when it is, and by how much, and in which direction.

The evidence is clear: most investors underperform the market. They (a) can't see the future, (b) make mistakes that keep them at a disadvantage, (c) accept high risk in their effort to distinguish themselves, and (d) spend money trying (in the form of market impact and transaction costs).

Of course, there are individuals who beat the market by substantial margins, and they become famous. The mere fact that they attract so much attention proves how rare they are. (That's the meaning of the adage "it's the exception that proves the rule.") Adding to return without adding commensurately to risk requires rare understanding of how money is made and what constitutes value. Far more managers promise it than deliver.

Most active managers go through times when their biases or their guesses lead them to do things that beat their assigned benchmark, which they attribute to their skill, and times that are the opposite, which they attribute to being blindsided by the unforeseeable (or to some defect in the benchmark). But these are two sides of the same coin, and in the long run the average manager adds little. Usually, active management will not allow you to beat the stock market, or to enjoy the fruits of the market without fully bearing its risk.

How do I view the outlook for stocks? The period since I started managing money in 1978 has been incredible. There were a few bad days and quarters, but through 1999 there wasn't a single year when the S&P 500 lost 5%. From 1978 through 1999, the return on the S&P 500 averaged 17.6% per year. That rose to 20.6% for 1991-99 and 28.3% for 1995-99. I doubt there's ever been a better 22-year run; to ask for more would be just plain piggish. But I don't think it'll be anything like that in the years just ahead, and of course there's been a considerable correction already.

The observers I most respect foresee single digit average returns for common stocks, and I agree. Equity returns have three components: profit increase, multiple expansion and dividend yield. The last is minimal and the second can't be counted on from here. So that means we're down to the rate of increase in corporate profits, which is likely to be in single digits. Single digit returns would be below the historic average, but after such a great 22-year run, a little less wouldn't be unreasonable.

<u>Hedge Funds</u> – Perhaps because they were new to the market, many who participated in the equity boom of the late 1990s were surprised by the suddenness with which their profits evaporated in the subsequent correction. Now they're looking for a new path to profit without risk, and many think they've found it in hedge funds. Their reasons for migrating include the good performance of hedge funds, especially amid the recent chaos, and the modest prospective returns available in the mainstream stock and bond markets.

First, how about a definition. Generally speaking, a hedge fund is an unregulated, private investment partnership whose manager receives a percentage of the profits. To "hedge" is to intentionally include positions that can be depended on to move counter to each other under most circumstances, and thereby to mitigate exposure to developments in the environment. "Hedge fund" is a misnomer for many of today's funds, however, because unlike the days when the term first arose, hedging has become far from universal.

The funds I'm interested in do hedge. They're designed to systematically take advantage of market inefficiencies and to capture managers' skill while limiting susceptibility to market fluctuations. Arbitrage, long/short, hedge and market-neutral strategies fall into this category. Most strive to earn returns in the teens on a consistent basis, with relative indifference and insensitivity to the performance of the mainstream markets. If they can do it, they're a great idea.

Today, hedge funds, also sometimes called "absolute return" funds, are being promoted heavily by brokerage firms, mutual fund organizations and investment advisers and popularized by the media. They are in the process of becoming the next investment fad. And there's good reason why they should. Especially given the weak competition I see coming from mainstream investment media like stocks, an appropriate mantra for the coming decade might be "low double digits ain't bad." If you can identify investment managers who possess enough skill to consistently deliver such returns, you should hire them. And there's a better-than-average chance they'll be found in the hedge fund arena, where the managers get to share in the profits.

However, a few caveats are in order:

- **Expectations still must be reasonable**. Investors must realize that very few managers are truly capable of earning before-fee returns of 12% or 15% steadily and with low correlation to the mainstream markets. Anything approaching 20% is Herculean.

- **Most returns really won't be "absolute."** I have seen lots of "hedge funds" and "market neutral funds" drop precipitously. That's because it's unusual for portfolio returns to be entirely divorced from their environment. "Zero correlation" with the market is rarely attainable; "low correlation" may have to suffice.

- **Money flows will play a big role**. In general, the good records have been built on small amounts of money. And those records will attract large amounts of money. There are several consequences.

  First, records simply may not be capable of extrapolation. **To handle more money, a manager may have to invest faster, reduce selectivity, put more dollars into each position, put on a larger number of positions, broaden the fund's range of activities, and/or add new staff members. All of these can have negative implications for returns.**

  Second, many of the best managers with skill <u>and</u> discipline are already closed to new money, or will reach the point when they are. Thus in the extreme, as Groucho Marx would have put it, "I would never invest my money with anyone who'd take it."

  And third, when there's too much money in an area, even funds that are closed can be affected. Long-Term Capital Management found others emulating its trades and eventually lost its opportunity because too much money had piled into its niches.

- **The wrong people will get money**. The rush to invest in an area gives money to managers who shouldn't get it. **When the best are closed, the rest will be funded**.

Second-string managers will split off from established groups and get money based on their old fund's record (regardless of how much of it they were responsible for). Thus, as the amount of money in the area rises, the average quality of the managers may fall.

- **Fees can eat up skill**. When the demand for funds outstrips supply, fund managers have the ability to raise fees and thereby appropriate for themselves a larger portion of their funds' returns.

- **Disappointments will be many**. Due to the factors enumerated above, the next few years will see many investors fail to get what they hoped for . . . as usual. One of my favorite sayings is **"what the wise man does in the beginning, the fool does in the end."** Over the last 20-30 years, a few talented hedge fund managers built successful records with relatively small amounts of capital. I believe the period ahead will see lots of people raise more than they should; thus it will have to be navigated with care.

All investment trends run a high risk of being carried to extremes. (For a shining example, take a look at venture capital in 2000.) Despite this, I think absolute return investing deserves your attention. But you should commit only after a lot of investigation and with your eyes wide open. Remember, there is no such thing as a silver bullet.

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The main thing I've tried to indicate here is that investing isn't easy. Or better put, <u>superior</u> investing isn't easy. It's easy to do average. In fact, there are vehicles – index funds – that exist for the explicit purpose of delivering average performance at low cost, and they are completely capable of doing so.

But most people want to do better than the average. They want higher returns, and achieving higher returns without assuming commensurately higher risk is the hard part.

It's easy to make guesses about the future but hard to be consistently more right in those guesses than your fellow investor, and thus hard to consistently outperform. Doing the same thing others do exposes you to fluctuations that in part are exaggerated by their actions and your own. It's certainly undesirable to be part of the herd when it stampedes off the cliff, but it takes rare skill, insight and discipline to avoid it.

The thing I'm surest of is that the solution doesn't lie in making guesses about the big-picture future. Rather, it lies with investors who possess skill, insight and discipline. There are times when they'll underperform – times like 1998-99, when aggressiveness was rewarded far more than caution. But if you can find those people, you should stick with them. For me, the laundry list of their desired characteristics is clear:

- adherence to the "I don't know" school of thought
- contrarianism, skepticism, modest expectations, humility and defensiveness
- eschewing of macro forecasts

- attention to the cyclical nature of things
- consciousness of timeframe
- concentration on valuation
- disdaining the hunt for the silver bullet
- awareness of prevailing investor psychology

You can go with opinions about the future. Everyone's got them, and what they call for in terms of investment behavior usually is obvious. In other words, the "I know" school makes investing sound easy – although in my opinion it's not often right.

Or you can join me in the "I don't know" school, where you must:

- face up to the uncertainty that surrounds the macro future;
- concentrate on avoiding pitfalls;
- invest in a few areas of specialization based on in-depth analysis, conservatively estimated tangible values and modest purchase prices; and
- be prepared for returns that trail the risk-takers when markets are hot.

This may be the less common path, and certainly the less rosy, but it's the one I'd much rather count on for success in the long run.

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