Memo to: Oaktree Clients

From: Howard Marks

Re: It's All a Big Mistake

Mistakes are a frequent topic of discussion in our world. It's not unusual to see investors criticized for errors that resulted in poor performance. But rarely do we hear about mistakes as an indispensible component of the investment process. **I'm writing now to point out that mistakes are all that superior investing is about. In short, in order for one side of a transaction to turn out to be a major success, the other side has to have been a big mistake.**

There's an old saying in poker that there's a "fish" (a sucker, or an unskilled player who's likely to lose) in every game, and if you've played for an hour without having figured out who the fish is, then it's you. Likewise, in every investment transaction you're part of, it's likely that someone's making a mistake. The key to success is to not have it be you.

Usually a buyer buys an asset because he thinks it's worth more than the price he's paying. But the seller sells the asset because he thinks the price he's getting exceeds its value. It's pretty safe to say one of them has to be wrong. Strictly speaking, that doesn't have to be true, thanks to differences in things like tax status, timeframe and investors' circumstances. **But in general, win/win transactions are much less common than win/lose transactions. When the dust has settled after most trades, the buyer and seller are unlikely to be equally happy.**

I consider it highly desirable to focus on the topic of investing mistakes. First, it serves as a reminder that the potential for error is ever-present, and thus of the importance of mistake minimization as a key goal. Second, if one side of every transaction is wrong, we have to ponder why we should think it's not us. Third, then, it causes us to consider how to minimize the probability of being the one making the mistake.

Investment Theory on Mistakes

According to the efficient market hypothesis, the efforts of motivated, intelligent, objective and rational investors combine to cause assets to be priced at their intrinsic value. Thus there are no mistakes: no undervalued bargains for superior investors to recognize and buy, and no over-valuations for inferior investors to fall for. **Since all assets are priced fairly, once bought at fair prices they should be expected to produce fair risk-adjusted returns, nothing more and nothing less. That's the source of the hypothesis's best-known dictum: you can't beat the market.**

I've often discussed this definition of market efficiency and its error. The truth is that while all investors are motivated to make money (otherwise, they wouldn't be investing), (a) far from all of them are intelligent and (b) it seems almost none are consistently objective and rational.

Rather, investors swing wildly from optimistic to pessimistic – and from over-confident to terrified – and as a result asset prices can lose all connection with intrinsic value. In addition, investors often fail to unearth all of the relevant information, analyze it systematically, and step forward to adopt unpopular positions. **These are some of the elements that give rise to what are called "inefficiencies," academics' highfalutin word for "mistakes."**

I absolutely believe that markets can be efficient – in the sense of "quick to incorporate information" – but certainly they aren't sure to incorporate it correctly. Underpricings and overpricings arise all the time. However, the shortcomings described in the paragraph just above render those mispricings hard to profit from. While market prices are often far from "right," it's nearly impossible for most investors to detect instances when the consensus has done a faulty job of pricing assets, and to act on those errors. Thus theory is quite right when it says the market can't be beat . . . certainly by the vast majority of investors.

People should engage in active investing only if they're convinced that (a) pricing mistakes occur in the market they're considering and (b) they – or the managers they hire – are capable of identifying those mistakes and taking advantage of them. Unless both of those things are true, any time, effort, transaction costs and management fees expended on active management will be wasted. **Active management has to be seen as the search for mistakes.**

Behavioral Sources of Investment Error

As described above, investment theory asserts that assets sell at fair prices, and thus there's no such thing as superior risk-adjusted performance. But real-world data tells us that superior performance does exist, albeit far from universally. Some people find it possible to buy things for less than they're worth, at least on occasion. But doing so requires the cooperation of people who're willing to sell things for less than they're worth. What makes them do that? Why do mistakes occur? The new field of behavioral finance is all about looking into error stemming from emotion, psychology and cognitive limitations.

If market prices were set by a "pricing czar" who was (1) tireless, (2) aware of all the facts, (3) proficient at analysis and (4) thoroughly rational and unemotional, assets could always be priced right based on the available information – never too low or too high. In the absence of that czar, if a market were populated by investors fitting that description, it, too, could price assets perfectly.

That's what the efficient marketers theorize, but it's just not the case. Very few investors satisfy all four of the requirements listed above. And when they fail, particularly at number four – being rational and unemotional – it seems they all err in the same direction at the same time. That's the reason for the herd behavior that's behind bubbles and crashes, the biggest of all investment mistakes.

According to the efficient market hypothesis, people study assets, assess their value and thereby decide whether to buy or sell. Given its current value and the outlook for change in that value, each asset's current price implies a prospective return and risk level. Market participants engage

in a continuous, instantaneous auction through which market prices are updated. The goal is to set prices such that the relationship between each asset's potential return and risk – that is, its prospective risk-adjusted return – is fair relative to all other assets.

Inefficiencies – mispricings – are instances when one asset offers a higher risk-adjusted return than another. For example, A and B might seem equally risky, but A might appear to offer a higher return than B. In that case, A is too cheap, and people will sell B (lowering its price, raising its potential return and reducing its risk) and buy A (raising its price, lowering its potential return and increasing its risk) until the risk-adjusted returns of the two are in line. That condition is called "equilibrium."

It's one of the jobs of a functioning market to eliminate opportunities for extraordinary profitability. Thus market participants want to sell overpriced assets and buy underpriced assets. They just don't do so consistently.

Most investment error can be distilled to the failure to buy the things that are cheap (or to buy enough of them) and to sell the things that are dear. Why do people fail in that way? Here are just a few reasons:

- Bias or closed-mindedness – In theory, investors will shift their capital to anything that's cheap, correcting pricing mistakes. But in 1978, most investors wouldn't buy B-rated bonds – at any price – because doing so was considered speculative and imprudent. In 1999, most investors refused to buy value stocks – also at any price – because they were deemed to lack the world-changing potential of technology stocks. Prejudices like these prevent valuation disparities from being closed.

- Capital rigidity – In theory, investors will move capital out of high-priced assets and into cheap ones. But sometimes, investors are condemned to buy in a market even though there are no bargains or to sell even at giveaway prices. In 2000, in venture capital, there was "too much money chasing too few deals." In 2008, CLOs receiving margin calls had no choice but to sell loans at bankruptcy prices. Rigidities like these create mispricings.

- Psychological excesses – In theory, investors will sell assets when they get too rich in a bubble or buy assets when they get cheap enough in a crash. But in practice, investors aren't all that cold-blooded. They can fail to sell, for example, because of an unwarranted excess of optimism over skepticism, or an excess of greed over fear. Psychological forces like greed, fear, envy and hubris permit mispricings to go uncorrected . . . or become more so.

- Herd behavior – In theory, market participants are willing to buy or sell an asset if its price gets out of line. But sometimes there are more buyers for something than sellers (or vice versa), regardless of price. This occurs because of most investors' inability to diverge from the pack, especially when the behavior of the pack is being rewarded in the short run.

The foregoing goes a long way to support Yogi Berra's observation that "In theory there is no difference between theory and practice. In practice there is."

Theory has no answer for the impact of these forces. **Theory assumes investors are clinical, unemotional and objective, and always willing to substitute a cheap asset for a dear one. In practice, there are numerous reasons why one asset can be priced wrong – in the absolute or relative to others – and stay that way for months or years. Those are mistakes, and superior investment records belong to investors who take advantage of them consistently.**

A Case In Point

Bruce Karsh and his distressed debt team have averaged returns of roughly 23% per year before fees and 18% after fees for more than 23 years without any use of borrowed capital. All eighteen of their funds have been profitable, and money-losing years have been quite scarce. **I consider this record nothing short of aberrant. You're simply not supposed to be able to make that kind of return for that long, and especially without the use of leverage.** Investing skill aside, what made it possible?

- Is it because it's called "distressed debt"? That can't be it; there's nothing in a name.

- Is it because distressed debt is an undiscovered market niche? That can't be it either; distressed debt may have been little-known and under-appreciated when we raised our first fund in 1988. But there can't be many institutional investors who haven't heard of distressed debt by now; certainly the secret's out.

- Can it be because people are unwilling to venture into the sordid world of default and bankruptcy? That might have been the case in the 1980s, but today most investors will do anything to make a buck.

So, then, why? I think it's largely a matter of mistakes.

At our London client conference in April, I listened as Bob O'Leary, a co-portfolio manager of our distressed debt funds, described his group's work as follows: **"Our business is often an examination of flawed underwriting assumptions."** In other words, it's their *raison d'être* to profit from the mistakes of others.

Hearing Bob put it that way gave me the immediate inspiration for this memo. The active investor only achieves above average performance to the extent that he can identify and act on mistakes others make. The opportunities invested in by our distressed debt funds are a glaring example. What's the process through which the mistakes arise?

- The analysis performed by a company's management, or the due diligence performed by a prospective acquirer, understates the stresses to which a business will be subjected

and/or overstates its ability to withstand them. Using Bob's terminology, they employ overly optimistic underwriting assumptions, particularly in good times.

- As a result, debt is piled on that turns out to be more than the company can service when things turn down.

- Just as companies and acquirers are often too optimistic in good times, debt holders tend to become too pessimistic in bad times. As a result, they become willing to sell the debt of financially distressed companies at prices that overstate the negatives and thus are too low, giving us the potential for superior returns with less-than-commensurate risk.

All three of these are foundational elements for success in distressed debt investing.

- The first two contribute to the creation of high-potential-return situations. **If no one underestimated risk and thus overloaded capital structures with debt, there wouldn't be many defaults and bankruptcies.** We call these lending decisions "the unwise extension of credit" or, alternatively, "stacking wood for the bonfire."

- **And if no one panicked in response to negative developments and scary prospects, and thus sold out too cheaply, there would be no reason to expect higher risk-adjusted returns from distressed debt than from anything else.**

Many of the biggest mistakes made in the business and investment worlds have to do with cycles. People extrapolate uptrends and downtrends into eternity, whereas the truth is that trends usually correct: rather than go well or poorly forever, most things regress to the mean. The longer a trend has gone on – making it appear more permanent – the more likely it usually is that the time for it to reverse is near. And the longer an uptrend goes on, the more optimistic, risk-tolerant and aggressive most people become . . . just as they should be turning more cautious.

So, for example, when the economy is thriving and profits are rising, people conclude that company operations should be expanded, acquisitions should be undertaken, and more debt can be borne. That same bullishness causes providers of debt to bestow larger amounts of money on weaker borrowers, at lower interest rates and with looser covenants. **Thus cycles are big sources of error, and pro-cyclical behavior is one of the biggest destroyers of capital.**

The point here is that one of distressed debt investing's great advantages is that it embodies an anti-error business model. Distressed debt investors . . .

- . . . almost never invest in companies where everything's going well and investors are enthralled; there's no such thing as a financially distressed company that everyone loves;

- . . . by definition rarely invest before the emergence of significant problems, hopefully meaning fewer negative surprises are left in the bag;

- . . . are in business to buy debt at significant discounts, often from forced or highly motivated sellers. "Distressed debt at par" is an oxymoron and, at least in theory, distressed debt investors are bargain hunters whose ardor rises as prices fall . . . not the reverse like so many other investors.

It's not that distressed debt investors can't make mistakes; just that their likelihood of doing so is reduced by the very nature of their investment activity. Anything that decreases an investor's chance of erring – even an involuntary safety mechanism – works to his advantage.

Distressed debt is, by definition, an area where:

- borrowers and lenders have made grave mistakes,
- at least some of those mistakes have come to light, and
- the stress, unpleasantness and uncertainty that attend a downturn often make debt holders sell out at the wrong time and price.

In other words, it's an area where negativism and error are crystallized, maximized and magnified. And nothing is more likely to make an asset too cheap than excessively negative psychology.

When we're out raising a new fund, investors often ask whether people have wised up such that they'll no longer make these mistakes. Thus far the answer has been no, and in fact there's no reason to believe there's been any progress at all up the learning curve. The proof? The distressed debt opportunities that built up in 2005-07 and flowered in the crisis of 2008 were some of the best we've ever encountered, and certainly the most plentiful.

<u>One Classic Mistake</u>

I want to take this occasion to touch on a favorite thought of mine. Investing consists of just one thing: choosing which assets to hold in order to profit in the future. Thus there's no getting away from the need to make decisions concerning the future.

In deciding which future to prepare for, you need two things: (a) an opinion about what's likely to happen and (b) a view on the probability that your opinion is right. Everyone knows about the former, but I think relatively few think about the latter.

In short, most people believe in their opinions. "Of course they do," you might say. "If they didn't have faith in their opinions, they wouldn't hold them." And that's the point. **Everyone's entitled to his or her opinion. But one of our favorite sayings around Oaktree states that "it's one thing to have an opinion, and something very different to act as if it's right."**

Clearly, our opinions are our opinions because we believe them. (We rarely hear anyone say "Here's what I think, and I'm probably wrong.") But just as clearly, we believe (or should believe) more in some of our opinions than others. The probability of being right about the

weather tomorrow in California, a B-rated bond issuer paying its debts, and Greece being part of the European Union in three years is different in each case. Few people would take issue with that.

If that's true, the reliance we place on each prediction – and the action we take in that reliance – should vary. **Yet, as I see it, most people who believe in forecasting come up with their opinions and then act on them with equal amounts of confidence. This is one of the greatest sources of investment error.**

It's perfectly okay to say you don't know something. It's also okay to say you have a view on what might happen but you're not so sure you're right. In that case you're likely to moderate your actions and emerge intact even if you turn out to be wrong. As Mark Twain put it, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." Or as Treasury Secretary Robert Rubin told the 1999 graduating class of the University of Pennsylvania, ". . . understanding the difference between certainty and likelihood can make all the difference." **Forecasting error is much less likely to prove fatal in the absence of excess conviction.**

I've mentioned before the frequency with which I feel I come across a particularly apt quote just when I need it for a memo in the making. Thus I'll close this section with one on the present subject from Yaser Anwar's "Exclusivo Listserv" of May 29:

> . . . while every one well knows himself to be fallible, few . . . admit the supposition that any opinion, of which they feel very certain, may be one of the examples of the error to which they acknowledge themselves to be liable. (John Stuart Mill, "On Liberty," 1859)

In other words, nearly everyone accepts that his or her opinion might be wrong . . . just not this time.

A Big Mistake in the News

A vast amount of ink and airtime is being devoted to the subject of JP Morgan's loss of multiple billions of dollars in its effort to hedge credit risk. People – and especially politicians – have seized on the loss to prove that Jamie Dimon isn't perfect and bank regulation is inadequate.

Clearly, JP Morgan made a mistake – or more than one. Jamie Dimon has described the hedge as "poorly designed," "sloppy" and "a terrible, egregious mistake." How could that be the case – and how could the result be such an enormous loss – in a field as inherently defensive as hedging? The answer's simple: as Charlie Munger once said to me about investing, "It's not supposed to be easy. Anyone who finds it easy is stupid." The truth is, it's hard to get it all right all the time, and that's just as true of hedging as it is of investing.

Hedging sounds easy: you own something, so you sell something to lessen the impact if your investment performs badly. But there are lots of ways to be wrong.

- **Hedging with the wrong thing**. Let's say you own some A but don't want to suffer the full impact if its price declines. Why not just sell short an equal amount of A to hedge? The answer is that owning A and simultaneously shorting A is the same as not owning anything. The long and short positions exactly offset each other, meaning you can't make (or lose) any money. That's not hedging, that's negating.

  You want to dampen fluctuations, not eliminate them. So you hedge by selling short something you think will move in sympathy with A, but not exactly. The hope is that by doing it very well, you can eliminate more of the risk of loss than you do of the potential for gain. That's the meaning of a "positive arbitrage."

  Buying Ford stock and simultaneously shorting Ford accomplishes nothing. So perhaps you buy Ford and short General Motors, which you think will perform less well, going up less than Ford or down more. But by transacting in two different assets, you by definition introduce the possibility of an unfavorable divergence. This is called "basis risk." In short, it's the risk that the behavior of the two assets relative to each other will differ from what you expected. For example, Ford goes down, giving you a loss, but rather than go down in sympathy (which would give you an offsetting gain on the short position), a favorable development at GM makes it go up, compounding your loss as the hedge goes against you.

- **Hedging in the wrong amount.** You hold 1,000 Ford shares, and you think that – given their likely relative performance – you should short 500 GM shares to hedge your risk. But it turns out that while they move in opposite directions, their relative movements aren't what you expected. Thus you either hedged too much (and thus you lose more on the hedge than you make on the underlying position) or you hedged too little (so the protection you sought doesn't materialize). There's no sure way to choose the right "hedge ratio."

- **Time risk.** The two sides of the position may work as you expect, but not when you expect. Thus the hedge may fail to work in the short run, meaning the loss on one side of the hedge may occur before the gain on the other, in which case you'll look flat-out wrong for a while. And if you're required (by regulation, margin call, capital withdrawals, etc.) to close out the position at that point, the result could be quite negative.

- **Insufficient liquidity.** If conditions or goals change, you might want to adjust or remove your hedge. But market developments in terms of liquidity might make it impossible to alter one or both sides of the position.

In other words, hedging consists of an attempt to cede some potential gain in exchange for a greater reduction in potential loss. It's a very reasonable course of action. But it doesn't necessarily have to work.

In attempting to set up effective hedges, there's little choice but to extrapolate past relationships between things. If they could be counted on to persist unchanged, there'd be little risk of being

wrong about which asset to hedge with, how much to hedge, or whether the two sides of the hedge will move simultaneously. But, just like everyone else in the investment world, would-be hedgers must understand that relationships that held in the past can't be counted on to hold in the future.

And let's remember, as *The New York Times* wrote on May 26, "Yes, Morgan lost big – but, as Mitt Romney has pointed out, someone else won." That's the bottom line on all investing. There's generally a right side and a wrong side to every investment. Which will you be on?

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Risk control isn't an action so much as it is a mindset. It stems largely from putting at least as much emphasis on avoiding mistakes as on doing great things.

Risk control – and consistent success in investing – requires an understanding of the fact that high returns don't just come along for the picking; others must create them for us by making mistakes. And looked at that way, we'll do a better job if we force ourselves to understand the mistake we think is being made, and why.

Risk control requires that we avoid the analytical and psychological errors to which others succumb.

In particular, risk control requires that we temper our belief in our opinions with acceptance of our fallibility.

In the end, superior investing is all about mistakes . . . and about being the person who profits from them, not the one who commits them.

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