Memo to: Oaktree Clients and Friends

From: Howard Marks

Re: Are You An Investor or a Speculator?

All of Oaktree's activities follow from our conviction that what matters most in determining the success or failure of an investment isn't whether it's in a fast-growing company, a desirable asset or a highly-rated security, but rather the relationship between the price you pay and what the asset is worth. We think no asset is so bad that there's not a price at which it's attractive for purchase, and no asset is so good that it can't be overpriced.

Thus, we think in order to invest successfully you have to know both the value of the asset and how the price relates to that value. The relationship in the marketplace of price to value is highly dependent on how things are being viewed at the time -- on the attitudinal factors determining investor behavior. We spend a lot of our time thinking (and some time writing) about the investor behavior embedded in asset prices, as we feel this will prove highly determinative of the success of the investments we make.

In an April 1991 memo entitled "The Pendulum," we discussed the market's usual oscillation between euphoria and depression, and thus between overpriced and underpriced. We think this swing, like other forms of cyclical fluctuation, is one of the few things in the investment world on which we can depend. And it's essential that we keep in mind where we stand in regard to that arc.

In short, we believe (and have witnessed many times over) that the easiest way to make unusually high risk-adjusted returns is to buy from depressed sellers and sell to euphoric buyers...thus to buy when assets are underpriced and sell when they're overpriced. The opposite is a nightmare. The greatest extremes in our experience include 1970, when the New York banks believed the Nifty-Fifty companies were so good that it essentially didn't matter what price you paid for their stocks (subsequent declines of 70% to 90% soon became common among the stocks of America's greatest companies), and 1990, when investors acted as if any company experiencing an iota of difficulty was practically worthless (the distressed debt funds we created that year returned about 50% per annum).

John Maynard Keynes said (roughly) that "a speculator is someone who takes risks of which he is aware, and an investor is someone who takes risks of which he is unaware." We think speculating, according to this definition, is more prudent than investing. It makes a lot of sense to purchase unpopular assets that promise excessive compensation for knowingly bearing risk. Buying high-priced, popular assets which "everyone knows have no risk" often proves terribly dangerous. Here's a case in point:

Earlier this year, our distressed debt fund bought a troubled company's commercial paper at 77 cents on the dollar. It was scheduled to mature later that month, but we thought there was little chance it would be paid off then. There appeared to be, however, a variety of other ways we could turn a profit. On the day we started buying, everyone assumed there would be no way out of a morass of overstated earnings, possible fraud, a resulting short-term cash squeeze and a likely bankruptcy filing. The issuer's common stock fell 86% that day. This confluence of circumstances presented an excellent opportunity for intelligent speculation under Keynes's definition -- we were buying into a company **everyone** considered highly risky.

It was reported the next day that a money market fund's management company had bought that same commercial paper from its fund's portfolio at par in order to keep the fund from reporting a principal loss. The article said "money market funds...traditionally invest in only the safest government and corporate bond securities." In other words, when the paper was considered to be among "the safest," the money market fund bought it at a 6% yield which incorporated no compensation for bearing the credit risk which subsequently proved to have been present. But after the scandal became common knowledge and the risks were on the table, we got to buy the money market fund's former holding at a price which we felt could give us an annual return of 20% or more. Bought when "riskless," this paper proved to be a disaster; purchased off the trash heap, we found it very attractive.

That leads us to the $64,000 question (although many of you already know my answer): Where do we currently stand? What attitudes and behavior characterize today's investors?

We think many "investors" have been buying with euphoria and belief rather than hesitance and skepticism. Many investors seem to be most afraid of being uninvested and missing out on the gains others are enjoying; that is, they're most worried about the risk of not taking enough risk.

Although many valuation indicators are at all-time highs and price gains in July set record after record, investors are quite willing to accept platitudinous rationalizations like "technology has brought a new era," "globalization offers unlimited opportunities for growth" and "we have nothing to worry about from the business cycle." Some analyses suggest that prices are fair today, implying that future returns will be proportional to the risks involved; by many other standards, prices are too high. **We find it very difficult, however, to conclude that stocks are underpriced, and thus that the potential exists for high and dependable returns from here**.

We find particularly troubling the oft-repeated mantra that "because the outlook continues to call for low inflation and stable interest rates, stocks can continue to rise." This statement was made at 6,000 and 7,000 on the Dow, and it was made in July at 8,200. But it can't be right regardless of the level of stock prices. Inflation is important because it determines interest rates, and rates are important because they determine valuation multiples for stocks. Thus, for every level of inflation and interest rates, there's a "right" level for stocks. What's the right level for stocks given today's conditions? Might it be below the current level?

It's worth noting in this connection, thinking back fifteen or twenty years to ancient history, that this bull market got its start because companies could be bought cheaper through the stock market than they could be created -- this fact kicked off the LBO boom that powered the stock market throughout the 1980s. Today, many companies' stocks have reached prices that no value-conscious entrepreneur would pay for the entire company.

The market seems extremely comfortable with the proposition that as long at the macro-environment remains benign, stocks prices can continue to appreciate at rates that far outstrip the growth of their issuers' profits, and thus the growth of their intrinsic value. Few market participants seem concerned about appropriate valuation levels -- the relationship between assets and their prices -- and this is a condition that we think must eventually have negative consequences. We are incredulous when, each day there's more news of economic equilibrium and stable rates, the market goes up another percent or so. We believe strongly that with corporate profits growing in the vicinity of their normal 10% or so, stable rates are not in themselves a reason why stock prices should rise at 20%-plus forever.

Today's combination of a stable economy, low interest rates, enormous cash flows and strong investor optimism has created a climate in which capital is available for both good investments and bad, and in which risk is rarely seen as something to be shunned. We see this in aggressive lending by banks; in the popularity of leveraged structures in many areas of investing; in the strong flow of equity IPOs (and their strong after-market performance); in the explosive issuance of high yield securities (including payment-in-kind preferreds and calamity-linked bonds); and in the massive amounts of capital available for every form of alternative investing. Each of these activities is appropriate at the right time and price, but each can be overdone. We feel the simplest adages remain the best, and few are better than "**what the wise man does in the beginning, the fool does in the end**." Every cycle eventually proves the wisdom of this old saw.

Are we "ringing the bell" on this bull market? Absolutely not; we've learned the folly of attempting to do so. We are not calling for a market collapse, but we do want to recap a few things that we feel are obvious:

> The market may be either fairly- or over-valued, but it is not under-valued. The best most bulls can say is that the extent of the current over-valuation isn't extreme.
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> With valuations having reached full levels, no one should expect stock prices to continue to out-pace company profits. It is certainly true that there are favorable developments in technology, productivity, taxation, inflation, monetary policy, geo-politics, demographics and labor tractability. These advances justify high multiples, **but not ever-higher multiples**. Valuations shouldn't be expected to expand ad infinitum just because the environment is benign and cash is flowing in; at some point, valuation has to matter.
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> In fact, as the above litany of favorable developments suggests, **everything has gone about as well as it could over the last fifteen years, making for a most atypical period in the market**. Unemployment and interest rates have halved, the index of consumer confidence has doubled, and the population of investors has exploded. But we think the

easy money has been made, and the improvement in these parameters is bound to subside. Anyone who thinks equity returns over the next fifteen years will look anything like the last fifteen is certainly bucking the odds.

It is still important to look for what's relatively cheap. For example, the fact that big stocks have recently been beating small stocks by the widest margins in history means small stocks are likely to have their day in relative terms. This was shown in August, when the Dow was down 7% and small stocks rose.

The possibility of a market decline certainly exists, and while "everyone" says a 5%, 10% or 15% dip would just be a buying opportunity, we wonder how investors would feel about a rerun of the 1973-74 experience, in which stocks declined an average of 2% a month for 24 months. At 8,200, we heard people say a 25% decline would only take the market back to the level of a year earlier -- implying that it wouldn't hurt. We doubt many investors who've never seen even a 10% "correction" would come through such a period with their equanimity unscathed.

What could cause a market decline? A drop in investor confidence -- perhaps the commodity that's most freely available today -- would likely be the key, but the reason is hard to foresee. **"We're not expecting any surprises,"** people say, and that has become our new favorite oxymoron. Surprises are never expected -- by definition -- and yet they're what move the market. (If they were expected, their effects would already be priced into the market, rendering a price reaction unnecessary.) The next surprise might be geo-political (oil embargo, war in Korea), economic (tight money, slowing profit growth) or internal to the market (competition from bonds at higher interest rates, discovery of a fraud), but it's most likely to be something that no one has anticipated -- including us.

What does all of this tell us? That we must return yet again to what may be the greatest Warren Buffet quote: **The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs**. Prudence is in short supply today, along with skepticism and disbelief. Thus we must be disciplined and selective in our investing today, and postpone our greatest enthusiasm for the bargains which are likely to be found in the months and years ahead.

Here at Oaktree, we continue to recommend that clients think about downside as well as upside and adopt protective strategies:

In **convertibles**, we continue to emphasize securities that are likely to fall much less than their underlying stocks and that are convertible into stocks that haven't soared, and we continue to take profits aggressively as prices increase (aren't we supposed to like things less, not more, as their prices rise?)

Our **high yield bond portfolios** continue to hold only the obligations of creditworthy U.S. and Canadian companies and emphasize cash-paying securities. Our bonds may have limited potential for price appreciation, but we think they're overwhelmingly likely to pay interest and principal as promised.

> In **distressed debt, real estate and control equity**, we continue to buy things that are found outside the mainstream sources of supply, that are as depressed in price as can be found in this environment, and that protect against losses through a call on strong asset values.

We have been privileged to read a recent letter from Julian Robertson to his investors. In it, Robertson compares today's fund managers to the Phoenician sea captains of thousands of years ago who were paid a percentage of the value of the goods they transported and thus were incentivized to design boats which emphasized speed over safety. This worked as long as the weather was good, but the storms that eventually came consigned the less safe ships to the bottom of the sea. He goes on as follows:

> The last several years have been a great period for the audacious captains with their fleets of fair-weather ships. There has not been a storm for years; perhaps climatic conditions have changed and there will never be another storm. In this scenario the audacious crew with its fleet of swift but flimsy ships is the cargo carrier of choice.
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> [Robertson's ship] will continue to be run as it has in the past; conservatively, making sure its crew and merchandise are safe.

This metaphor suits Oaktree exactly; we couldn't say it better. Being prepared for stormy weather, even if it could cost us some of the easy money in good times, is certainly the course for us.

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