

Memo to: Oaktree Clients

From: Howard Marks

Re: Déjà Vu All Over Again

What good is history? After all, it's in the past.

The truth is, history can be one of our greatest aids . . . in investing as in life. Here in the fifth decade of my investment career, I feel a lot of my ability to add value comes from the amount of history I've witnessed and the significance I've extracted from it.

Regular readers know I often include time-tested quotations in my memos. Why wouldn't I? They've endured precisely because they're so relevant and so well put. Why try to reinvent the wheel, rewriting them, only to come up short? On this subject, several stand out. I've used them all before, some more than once:

Those who cannot remember the past are condemned to repeat it. (George Santayana)

The farther back you can look, the farther forward you are likely to see. (Winston Churchill)

History doesn't repeat itself, but it does rhyme. (Mark Twain)

Contributing to . . . euphoria are two further factors little noted in our time or in past times. The first is the extreme brevity of the financial memory. In consequence, financial disaster is quickly forgotten. In further consequence, when the same or closely similar circumstances occur again . . . they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have insight to appreciate the incredible wonders of the present. (John Kenneth Galbraith)

One of the greatest differences between humans and animals is supposed to lie in the fact that we can learn other than through direct experience. We don't have to sit on a hot stove to learn not to do it. We can learn from history and from lessons passed on by our predecessors – things they experienced or learned from others in turn – so that we needn't experience them ourselves. But to enjoy this benefit, we must pay heed to the people and events that preceded us.

As Twain said, the events of history don't repeat exactly. It's rarely the very same thing over and over. In investing, for example, the duration and amplitude of fluctuations are rarely the same from cycle to cycle. (It drives me crazy when people say, "high yield bonds tend to default around the second anniversary of their issuance." That happened to be the average for one particular period, but there's no reason for it to be true, and thus no reason it should be a useful rule going forward.)

But as Twain also said, there are themes that rhyme. It's what I would call "tendencies" or "behavioral patterns" that present the important lessons. The tendency of investors to overlook or forget the past is noteworthy. So is their habit of succumbing to emotion and swallowing tall (but potentially lucrative) tales. In particular, people tend to forget the cyclical nature of things, extrapolate past trends to excess, and ignore the likelihood of regression to the mean.

The tech bubble may not recur anytime soon. No online grocer may ever again sell at 200 times revenues. There may never be another CDO-squared or SIV. Those aren't the things that matter. **But there's sure to be another cycle, another bubble and another crisis. There'll be another time when people overpay for exciting investment ideas because their future appears limitless, and then a time of disillusionment and price collapse. There'll be another period when leverage is embraced to excess, and then, consequently, a period when it gets people killed. And there'll certainly be another time when people can only imagine the possibility of gain, and then one when – after huge sums have been lost – they can think only of further declines.**

These are the kinds of things that rhyme. If we stay alert, we can anticipate and recognize them and thus avoid the losses and opportunity costs they bring so reliably.

The Death of Equities

Sometimes the ideas for my memos come from the gradual accretion of insights over a long period of time, and sometimes they come from a single inspiration. This time it's the latter.

Lying in bed sleepless on Sunday the 11th, while on a business trip to South America, I dug into my Oaktree bag for something to read. I came across a reprint of "The Death of Equities" from *BusinessWeek* magazine of August 13, 1979. I'd spoken about it over lunch with Josh Kuntz of Rivulet Capital, and he was good enough to send it to me at my request. As I read it thoroughly for the first time in 33 years, my wife Nancy's battle cry rang out: "This calls for a memo."

This was a seminal article, signaling a tectonic shift in investing. Here was its thrust:

- Seven million shareholders have defected from the stock market since 1970.
- The Labor Department has interpreted ERISA as giving institutions that invest pension money the ability to go beyond listed stocks and high grade bonds and into "shares of small companies, real estate, commodity futures and into gold and diamonds." Thus they were "pouring money into . . . mortgage-backed paper, foreign securities, venture capital, leases, guaranteed insurance contracts, indexed bonds, stock options, and futures."
- "Whereas stocks once made up 80% of mutual fund assets, today that figure has slumped to less than 50%."
- "Few corporations can find buyers for their stocks."
- All of these things were the result of thirteen years of rapid inflation and ten years of returns on equities averaging less than 3% per year.
- "The Labor Department ruling is just one more in a nearly endless string of unhealthy things that have happened to the stock market over the past decade."
- "This 'death of equity' can no longer be seen as something a stock market rally – however strong – will check."
- "For better or for worse, then, the U.S. economy probably has to regard the death of equities as [a] near-permanent condition – reversible some day, but not soon."

According to *BusinessWeek*, then, it was all over for equities. No one would ever buy them again.

Whatever caused it, the institutionalization of inflation – along with structural changes in communications and psychology – have killed the U.S. equity market for millions of investors.

What a negative article, ostensibly the death knell for an entire market. **What was the shift that it marked? Simply this: the end of a lost decade for equities and the beginning of the greatest bull market in history.**

There's literally a lifetime of memos in that one magazine article, but I'll spend a little less than that dissecting it. I hope you'll find these comments useful.

Yogi Lives

Lawrence "Yogi" Berra was a baseball catcher and an integral part of the New York Yankees' successful dynasty in the middle of the twentieth century. While a great player, he was also the undisputed king of the tortured phrase or malapropism. Here are a few:

- "It ain't over 'til it's over."
- "Ninety percent of the game is half mental."
- "When you come to a fork in the road, take it."
- "Always go to other people's funerals, otherwise they won't go to yours."

In fact, Yogi supplied the title for this memo, saying "It's déjà vu all over again." Rising to his own defense, however, he denied the tendency for which he is so well known, saying, "I really didn't say everything I said."

Do people really say things like these? Or was it just Yogi? Well, the writer of "The Death of Equities" gave him stiff competition:

. . . with ever-escalating real estate prices . . . land is a hedge against loss.

One of the few things I'm sure of is that no price will be "ever-escalating."

Individuals . . . are flocking into money market funds to nail down high rates.

In a money-market fund, the period for which you nail down a rate of interest is measured in just days. In fact, the prime drawback of holding short-term paper is its failure to lock in a yield. One of the biggest mistakes I've witnessed took place when people invested in one-year certificates of deposit in 1981 at 16%, rather than multi-year CDs at rates a little lower.

For investors . . . low stock prices remain a disincentive to buy.

What the writer is saying is that low prices point up how badly stocks have done over the preceding period and thus discourage investors from participating in the market. This is totally illogical, but in the investment world we hear things like it every day:

- “Everyone knows XYZ is underpriced.” If everyone knows it’s underpriced, why haven’t they bought it and forced up its price?
- “Nobody will touch ABC; it’s too risky.” If they know it’s risky – presumably because its price is too high – and are shunning it or selling, why hasn’t its price settled down to a level where it’s safe?

The writer continued:

Indeed, the average stock price is now about 60% of the replacement value of the underlying assets . . .

. . . companies have jumped on low stock prices to set off the biggest takeover binge in history . . .

. . . buying at these prices is cheaper than building.

The writer would look smarter today if he had recognized the implications of the fact that stocks were selling for less than their underlying asset value, and that companies were buying up other companies for that reason. But he didn’t. He also didn’t ask why, if it was smart for companies to buy other companies’ shares, it didn’t make sense for investors to buy those same shares. (Note: it was largely the ability to buy companies cheaper in the stock market than you could build them that gave pioneers of leveraged buyouts such as KKR, Apax and Warburg Pincus the great returns on their purchases in the 1970s.)

It would take a sustained bull market for a couple of years to attract broad-based investor interest and restore confidence.

This one reminds me of my absolute favorite Yogi-ism: “Nobody goes [to that restaurant] anymore. It’s too crowded.” Wait a minute: how can a restaurant be crowded if nobody goes there?

Likewise, in this case, according to the writer, it will take a bull market to attract investor interest and confidence. That sounds reasonable. But isn’t investor interest and confidence a prerequisite for a bull market? Without it, how can a bull market get started?

The answer is that when prices are low enough, stocks can begin to rise without help from a full-fledged bull market, just as when they’re high enough, stock prices can collapse under their own weight.

The bottom line here is simple, and I’m thoroughly convinced of it: **Common sense isn’t common. The crowd is invariably wrong at the extremes. In the investing world, everything that’s intuitively obvious is questionable and everything that’s important is counter-intuitive. And investors prove repeatedly that they can be less logical than Yogi.**

The Penalty of Youth

Let’s think back to Galbraith’s statement that “Past experience . . . is dismissed as the primitive refuge of those who do not have insight to appreciate the incredible wonders of the present.” In other words, when a hot new investment fad gets rolling and an idea is elevated to bubble status,

those with memory of the past – who might point out that the merits are overstated and the price is too high – are dismissed as “too old to get it.”

The Money Game, written in 1968 by George Goodman under the pseudonym Adam Smith, included among its characters the Great Winfield. Even though he was the dean of the brokerage office, he was able to make money in the hot stocks of the day. When asked how, he said, “My solution to the current market: kids. This is a kids’ market. . . . The strength of my kids is that they are too young to remember anything bad, and they are making so much money they feel invincible.” This exactly parallels Galbraith’s observation.

In other words, veterans are often held back by experience and historic norms, and thus they miss out on the “new thing.” Only those who are free of those strictures can participate fully in the latest miracle . . . as long as it lasts.

“The Death of Equities” leaned heavily on this line of reasoning, but in the opposite direction. You have to be young, it said, not to comprehend the new miracle, but to note the obsolescence of the old standby:

Only the elderly, who have not understood the changes in the nation’s financial markets, or are unable to adjust to them, are sticking with stocks.

Today, the old attitude of buying solid stocks as a cornerstone for one’s life savings and retirement has simply disappeared. Says a young U.S. executive: “Have you been to an American stockholders’ meeting lately? They’re all old fogeys. The stock market is just not where the action’s at.”

And what consistently provides the foundation for this insistence that the game has permanently changed? Four of the most dangerous words in the investment world: it’s different this time.

When investors choose to believe that historic valuation standards have become irrelevant; that one industry or product can maintain superior growth and profitability in perpetuity; or that one asset or market can outperform all the others forever regardless of how high its price goes in the process – that is, that trees can grow to the sky – the bubble is invariably undergirded by a steadfast belief that it’s different this time. Here’s the support *BusinessWeek* advanced:

Says Alan Coleman, dean of Southern Methodist University’s business school, “We have entered a new financial age. The old rules no longer apply.”

When you see or hear words like these, you should go on high alert. Sometimes the world changes and the past becomes irrelevant, but most of the time I’ll take the other side of that bet.

Getting to the Truth

In some ways, understanding the market is like mathematics. You don’t have to be knowledgeable regarding the specifics of the underlying subject matter to know whether a conclusion makes sense. You just have to be able to apply principles, tell logic from illogic, and exclude the deleterious effects of emotion and psychology.

Let's dissect "The Death of Equities" in that vein. What it says is that inflation has eaten into the outlook for the economy and companies, and there's no hope for improvement. Thus people have been throwing in the towel and selling stocks. Other things have come into vogue, attracting the capital that used to be invested in stocks. Mutual fund investors have turned their attention elsewhere. Most corporations can't issue new equity because of the dearth of buyers. Stocks have gone through a decade in which their absolute return was negligible and their real return was negative. They're selling below replacement value, showing how poor psychology is. They face a litany of negatives, without any real possibility of relief; that's the writer's "nearly endless string of unhealthy things that have happened to the stock market over the past decade."

The negative factors are clear to the average investor. And from them he draws negative conclusions. But the person who applies logic and insight, rather than superficial views and emotion, sees something very different.

He sees an asset class that is unloved. He sees stocks that have cheapened for a decade – once dividends have been subtracted from the returns, and especially when prices are viewed relative to earnings. He sees securities that are priced below the value of the underlying assets on which they have a claim. He sees outflows of capital that, rather than being a negative, have lowered prices and can give rise to a strong price rebound when and if they reverse. Most of all, he sees an asset class to which no optimism is being applied.

If I were asked to name just one way to figure out whether something's a bargain or not, it would be through assessing how much optimism is incorporated in its price.

- No matter how good the fundamental outlook is for something, when investors apply too much optimism in pricing it, it won't be a bargain. That was the story of the Internet bubble; the Internet was expected to change the world, and it did, but when the optimism surrounding it proved to have been excessive, stock prices were decimated.
- Conversely, no matter how bad the outlook is for an asset, when little or no optimism is incorporated in its price, it can easily be a bargain capable of providing outsized returns with limited risk.
- Even with a bad "story," the price of an asset is unlikely to decline (other than perhaps in the very short term) unless the story deteriorates further or the optimism abates. And if there's no optimism built into its price, certainly the latter can't happen.

It was primarily this line of reasoning that allowed me to feel positive in the teeth of the financial crisis in late 2008. The outlook was as bad as it could get – total meltdown – and prices clearly incorporated zero optimism. How, then, could buying be a mistake (providing the world didn't end)?

In "The Tide Goes Out" (March 18, 2008), I described the three stages of a bear market. The third stage occurs when everyone becomes convinced that things can only get worse. Invariably this represents a great buying opportunity. And certainly it was such a level of negativity that "The Death of Equities" documented.

So the insightful, unemotional, contrarian investor will read an article like “The Death of Equities” and conclude that things are about as bad as they can get. And if things can’t get worse, they’ll probably get better eventually. It’s no more scientific than that. **If in mid-1979 people thought things could only get worse, there was no optimism to evaporate. That meant the litany of negatives actually foreshadowed something very different: The Rebirth of Equities. And that’s exactly what happened.**

The S&P 500 gained 18.4% in 1979, the year “The Death of Equities” was written, and went on to average 18.9% a year for the next 20 years. There were only two down years during that span: a measly 4.9% in 1982 and 3.1% in 1990. This has to have been the best 21-year period in the modern era. **Importantly, the stage had been set for this rise in 1979 by the accumulation and excessively pessimistic discounting of negatives.**

Way back in February 1993 – it would be yellowed by now, except that electronic copies don’t turn yellow – I wrote a memo entitled “The Value of Predictions, or Where’d All This Rain Come From?” One of the things it discussed was the tendency of forecasters to extrapolate, especially when a trend has gone in one direction for a long time. They tend to conclude it will go that way forever . . . and increasingly so just as it becomes more likely to revert to the mean.

In the memo, I mentioned that California had undergone a five-year drought. And that scientists had concluded from looking at ancient trees that a fifty-year drought couldn’t be ruled out. And that torrential rainstorms had begun just a few months later.

That’s the way it goes. As something goes in one direction for a while, people conclude increasingly that it always will . . . often just when the likelihood grows that it will reverse instead. And that was the greatest shortcoming of “The Death of Equities.” **The extrapolator threw in the towel on stocks, just as the time was right for the contrarian to turn optimistic. And it will always be so.**

Go Around, Come Around

It’s easy with the benefit of hindsight to see that the writer of “The Death of Equities” was too negative at the bottom. But being too negative isn’t the only pitfall. Most people also tend to be too positive at the top.

The bookend to “The Death of Equities” is the work published in the 1990s by Jeremy Siegel, a highly respected professor of finance at the Wharton School and the author of *Stocks for the Long Run*. Through his work, Siegel showed that in almost two centuries, there had never been a 30-year period in which stocks didn’t outperform cash, bonds and inflation, and very few such ten-year periods. Based on the consistency of this record, Siegel labeled stocks very safe (as long as you hold them for the long run). In fact, I heard him tell an audience that risk-averse investors should have 80-odd percent of their net worth in stocks, and risk-tolerant investors should have well over 100%.

Siegel’s research contributed to the fervor for equities that characterized the 1990s. And as stocks did better, the appetite for them rose. The period 1995-99 saw a compound average return of 28.6% on the S&P 500, the greatest five years in history. The ardor this reflected was explosive. Arguments were advanced to the effect that stocks – and tech stocks in particular – could only rise, and that they had to rise faster than anything else.

Again the enemy was extrapolation. The average annual return had risen from about 10% for 1929 to 1980, to 20.4% for 1980 to 1989, and to 28.6% for 1995 to 1999. But investors drew the wrong conclusions, the inverse of those of “The Death of Equities”: they thought the good times could only roll on. However:

- They forgot that in the long run the gains of stocks stem primarily from growth in corporate profits, and that profits don’t grow anywhere near 20-30% a year.
- They ignored the possibility that the ultra-high returns of the 1990s had borrowed from future returns.
- They failed to wonder whether the adoration of stocks had lifted their prices to dangerous heights.
- They asked “What has been the historic return on stocks?” and bought based on the favorable answer. But they didn’t ask “What has been the historic return on stocks after they’ve risen almost 19% a year for 21 years?” or “What has been the historic return on stocks if bought at price/earnings ratios in the 30s?” The answer to these latter questions would have been very different.

Extrapolation was at the root of these omissions, disregarding the possibility that events had changed the environment and thus the outlook.

What did I say about the drought and rain? Of course, after stocks had done well enough in the 1990s to encourage maximum bullishness and maximum allocations, their returns were primed for regression to the mean. **And so stocks lagged bonds for the first time in the thirty years ending late last year.**

What’s the lesson here? Not that history always repeats, or that it never repeats. And not that stocks can only do well or only do poorly. But rather that the trends that lead up to a point in time have a profound effect on people’s thinking and on the environment, and thus on the trends that will occur thereafter. That price gains increase danger and price declines increase opportunity. And that most investors and observers tend to be too positive at the top and too negative at the bottom.

These lessons are invaluable. The study of history makes them clear, just as ignorance of history makes them potentially lethal.

One More Round

I’m amazed at how often, just as I’m about to complete a memo, I come across the right coda with which to bring it to an end. This time I found it in *The Wall Street Journal* of March 12, just a day after I’d started writing.

In an article entitled “Why Stocks Are Riskier than You Think,” Zvi Bodie and Rachelle Taqu go through – in my opinion – another Death of Equities-like recitation. I won’t discuss the article in depth, but I will point out some of its illogicalities:

- It says “despite the assurances of the financial industry, stocks are *always* a risky investment.” This isn’t very helpful. The outlook for stocks is always uncertain, perhaps even risky, but it’s essential to note that they aren’t always equally risky. They’re riskier

when valuations are high and prices embody great optimism, and they're much less risky when the reverse is true (see 1979).

- It says “the longer you hold [stocks], the better your chances of getting blindsided by a downturn.” I find this highly misleading. The longer you do anything, the better the chance that something bad will happen. But that doesn't mean you shouldn't do it, or that it's safer to do it for just a short time. Maybe the participant for a short period will time it just wrong and run straight into a bad patch. And maybe by holding stocks for just a short time he'll miss out on the long-term benefits. The question isn't whether something bad can happen to the long-term investor in equities, but what's likely to happen overall, considering good times as well as bad. And whether, given his particular circumstances, an investor can survive the bad while waiting for the good to arrive.
- In deciding how much risk a prospective retiree can bear, the authors make reference to not wanting to see 2008-style losses of 30% to 40% ever again. But using the worst time in generations to argue against investing in stocks is no better than using the best time to argue for it. What matters isn't the best or worst possible outcome (or even the single most likely outcome). What matters is the range of outcomes and their respective probabilities and consequences. No one observation provides a very useful perspective.
- The strategy the authors spend the most time recommending is what's called a “zero-cost collar” where, for example, you buy an S&P 500 ETF at \$136, buy a put at \$116 (ensuring against losses beyond that) and get the money with which to buy the put by selling a call at \$143 (giving up any gains above that). The good news is that one option pays for the other so the collaring is free, and that your downside is limited to 15%. But the bad news is that to go with your maximum loss of 15%, you have a maximum gain of 6%. I'm not crazy about that tradeoff. The benefits of the strategy seem largely illusory and the posture excessively defensive.

This article isn't without merit. My complaint is that it's simplistic – and the last thing that should be done regarding investing is to make it appear simple. It's also biased to the negative side at a time when stocks appear reasonably situated.

- Stocks have returned almost nothing over the last twelve years.
- For the first time, the 30-year return on stocks has been below the return on bonds.
- The price of the S&P 500 index is still 8% below its 2000 high, while its companies' earnings per share have nearly doubled over the intervening period.
- Thus the p/e ratio on the S&P 500 is in the low double digits, a substantial discount from the post-World War II norm and down from the low 30s at the peak.
- Just as in 1979, institutional investors have lost interest in equities and are looking increasingly to alternatives. The love affair with equities that ran from 1979 to 1999 seems to be over.
- Allocations to equities have been cut substantially in favor of bonds and alternatives. For example, according to *What I Learned This Week* of March 15, “The ICI reports that \$408 billion was redeemed from U.S. equity mutual funds between 2007 and 2011 and \$792 billion was invested in U.S. bond funds in the same period.”

The story isn't as hopeless as it was in 1979, but it is uniformly negative. Thus, while I don't expect an equity rally anything like what followed on the heels of "The Death of Equities," I don't find it hard to conjure up positive scenarios.

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The media usually gets it wrong, and the pieces that get the most attention tend to be highly sensational and to get it the most wrong. This is one of the many reasons why the deck is stacked against the average investor. "The Death of Equities" would have gotten you out or kept you out of the stock market at very attractive levels in 1979. Professor Siegel's work would have gotten you to increase your holdings at high prices in the 1990s. And this new article argues against stocks at a time when valuations are below average, investors have turned against them, and companies are doing well.

The great irony here is that the extrapolator actually thinks he's being respectful of history: he's assuming continuation of a trend that has been underway. But the history that deserves his attention isn't the recent rise or fall of an asset's price, but rather the fact that most things eventually prove to be cyclical and tend to swing back from the extreme toward the mean.

History amply demonstrates the tendency of investors and commentators alike to be pessimistic when the negatives collect, depressing prices, and optimistic when things are going well and prices are soaring. The lessons of history are highly instructive. Applying them isn't easy, but they mustn't be overlooked.

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