Memo to: Oaktree Clients

From: Howard Marks

Re: Now What?

My memos mostly try to explain what's been going on in the financial arena and how things got that way. With three published this past summer plus December's review of the lessons of 2007, I've done a lot of that. Hopefully they were helpful. Given what I consider to be the importance of the current situation, I have decided to venture beyond the familiar ground and into an area where I'm on shakier footing: the future. Before doing so, however, I can't resist the temptation to recap how we got here.

Boom

There's a process through which bullish excesses set the stage for bearish corrections. It's known as "boom/bust," a label that succinctly describes the last few years and, I think, the next few.

- In 2001-02, heavy borrowing to overbuild optical fiber capacity led the telecommunications industry to the brink of financial collapse. This came to a head around the time that scandals were unearthed at Enron, WorldCom, Adelphia, Tyco and Global Crossing. This combination of events – set against the backdrop of a sluggish economy and some very negative geo-political events – led to a **widespread crisis of confidence regarding corporate financial statements, corporate managements and corporate debt.** The environment was quite bleak.

- The Fed took interest rates as low as 1% to offset the negative effects of these events and others. Because of this – and with U.S. equities having fallen for three consecutive years for the first time since the Great Depression – many investors concluded that their **return aspirations couldn't be met in traditional investments**. Pressure for higher returns had the effect of increasing the acceptance of alternative investments, hedge funds, emerging market securities, leverage and financial innovation . . . in the process, suppressing customary risk aversion.

- **Leverage and risk taking became the dominant features of the financial landscape**, facilitated by a "global wall of liquidity." The low promised return on most investments, the pressure for more and the availability of low-cost capital all combined to make leveraged structures the flavor of the day.

- Importantly, much of the growth in leverage took place free of regulatory oversight. In the past, the creation of debt was limited by margin requirements, Fed regulations, bank capital requirements and bankers' prudence. But under the new order, **an**

explosion of non-bank lending rendered the traditional restraints impotent, with unregulated hedge funds and derivative traders doing what financial institutions wouldn't or couldn't. And when traditional providers of capital did participate, competition to lend caused them to join in the trend to "covenant-lite," "PIK/toggle" and other loosey-goosey structures.

- Financial innovation enjoyed enormous popularity. **The application of leverage, securitization and tranching permitted debt backed by assets such as mortgages to be created and sold around the world.** This process, it was said, enabled just the right level of risk and return to be delivered to each investor.

- Financial sector participants and observers concluded that the world had been made a less risky place by disintermediation (in which banks sold off loans rather than hold them), adroit central bank management and developments that made debt more borrower-friendly. In many cases, this **sense of reduced risk** encouraged individuals to assume correspondingly more risk.

- Because the structured products were so new, sophisticated and opaque, **high ratings would be needed** if they were to gain acceptance. Wall Street's persuasiveness, combined with the rating agencies' susceptibility, caused the needed ratings to be assigned. Thus the final element was in place for the financial innovations to gain widespread popularity.

- Among the innovations, **collateralized debt obligations**, or CDOs, deserve particular mention. CDO originators would issue tranches of debt with varying levels of priority regarding the cash flows from debt portfolios assembled with the proceeds. In many cases, the portfolios consisted heavily of residential mortgage-backed securities, each comprised of large numbers of mortgages, often subprime. I find it inconceivable that buyers of CDO debt really understood the riskiness of the tranched debt of leveraged pools of tranched mortgage securities underlaid by thousands of anonymous loans. But solid ratings made the debt highly salable.

- With vast sums available for high-fee investment products, **managers' incentives favored the rapid amassing and deploying of large pools of capital**. The usual effect of such a process is to drive up asset prices, drive down prospective returns and narrow investors' margin of safety. It was no different this time.

- Due to widespread prosperity, large amounts of capital flowing into the mortgage market, and the flowering of the American dream of home ownership (and of wealth therefrom), **rapid home price appreciation became a prominent feature of this period**. Price gains further inflamed the people's hopes, and behavior regarding residential real estate grew increasingly speculative.

- Thanks to the combination of the wealth effect from home appreciation, the ability to borrow liberally against increased home equity, and strong competition among financial institutions to provide credit, **consumer spending grew faster than**

consumer incomes, propelling the economy ahead but rendering households increasingly leveraged.

As this process moved onward, it depended on a continued supply of the underlying ingredients: confidence, liquidity, leverage, risk tolerance and acceptance of untested structures. The resulting "virtuous circle" was described in glowing terms just as its perpetuation was growing increasingly unlikely.

<u>Bust</u>

It took five years or so for the bullish background described above to be established in full. As usual, far less time was required for the excesses to be exposed and the process of their unwinding to begin. The air always goes out of the balloon a lot faster than it went in.

Regular readers know that if there's one thing I believe in, perhaps more strongly than anything else, it's the fact that cycles will prevail and excesses will correct. For the bullish phase described above to hold sway, the environment had to be characterized by greed, optimism, exuberance, confidence, credulity, daring, risk tolerance and aggressiveness. But these traits will not govern a market forever. Eventually they will give way to fear, pessimism, prudence, uncertainty, skepticism, caution, risk aversion and reticence. A lot of this has happened.

Busts are the product of booms, and I'm convinced it's usually more correct to attribute a bust to the excesses of the preceding boom than to the specific event that sets off the correction. But most of the time there is a spark that starts the swing from bullish to bearish. This time it came in the world of subprime mortgages.

Subprime mortgages (as if there's a person alive who doesn't know) are loans made to people whose credit scores fall below the "prime" standards that government-sponsored agencies Fannie Mae and Freddie Mac require of the loans they buy. In the last few years, as part of the rosy process described above, subprime mortgages were issued in rapidly increasing numbers. They were often placed by independent mortgage originators paid for volume rather than credit quality; through salesmanship that caused excessive amounts to be borrowed; for the purchase of highly appreciated homes; with temporarily low "teaser" interest rates; in structures that reduced or delayed principal repayment; and without requiring borrowers to document the incomes they claimed. **Of course, with the clarity that comes with hindsight, everyone now sees that these elements constituted breeding grounds for trouble.**

Anyway, here's how things went:

- In late 2006 and early 2007, **defaults among subprime mortgages began to rise**. But as is usually the case with the first crack in the financial dam, this attracted little attention and was generally described as an "isolated development."

- By July 2007, however, the defaults became serious and could no longer be ignored. This precipitated **wholesale downgradings of CDO debt securities**.

- The **defaults and downgrades led to price declines**. This caused leveraged investment entities that held CDO debt to receive margin calls and capital withdrawals. When they went to the market to sell the debt to raise cash, they found either that it couldn't be sold or that the bids were way below fair value. When some investors announced significant losses, the mark-to-model approach often used for pricing was questioned and then rejected in favor of market prices.

- In times of crisis, you sell what you can sell, not what you want to sell. Many of the entities that held CDO debt also held leveraged loans (the new term for bank loans, since most banks no longer hold on to loans for long). Thus, **when they couldn't get fair prices for CDO debt, they sold leveraged loans**, putting their prices under pressure as well. And when the creation of new Collateralized Loan Obligations slowed to a trickle, the decline in demand from CLOs removed an important prop from loan prices.

- Some leveraged entities that couldn't sell enough CDO debt (or other holdings) at fair prices suspended withdrawals. In extreme cases, they melted down and investors lost everything. In sum, **entities that had borrowed short to invest in longer-term, potentially illiquid assets fell victim to their funding mismatch**. The precariousness of this position is easy to overlook when all is going well, asset prices are firm and capital is freely available. But it regularly leads to ruin when financial crises take hold.

- With these developments, **psychology turned from positive to negative overnight**. Lenders became more nervous, requiring repayments, raising lending standards and refusing to roll over maturing loans. In particular, there was a dramatic contraction in the market for commercial paper backed by assets (rather than by promises from creditworthy firms).

- Among other things, **the investment banks found their balance sheets clogged with debt for buyouts** that they had promised to place ("bridge loans") before the music stopped, and the debt became unsalable on the agreed terms. This cut into their ability to make new loans. Discount sales were talked of, and funds were formed to buy up the loans.

- **Central banks stepped in to calm the waters**. The European bank injected significant capital. The Fed cut short-term rates. The Bank of England guaranteed deposits at Northern Rock, a building society (S&L), and extended emergency loans. And so the panic eased. The reaction seemed to be "boy, I'm glad that's over." But the calm lasted only from early September to mid-October.

- CDO downgrades continued, price declines deepened, and **financial institutions began to report third-quarter losses on mortgage-related holdings.** These occurred around the world, but they were concentrated in U.S. commercial and investment banks. There was some surprise when it turned out that, despite disintermediation, banks still had ended up holding the bag. Also surprising was the fact that new and unheard-of types of (usually bank-controlled) off-balance-sheet entities – structured investment vehicles ("SIVs") and conduits – were among the big losers. Because some couldn't renew their asset-backed financing, their debts had to be taken onto the banks' balance sheets (to avoid holding fire sales in order to repay lenders), bringing the supposedly alchemical process of disintermediation full circle.

- **Banks warned of fourth-quarter losses**, people wondered whether the warnings were sufficient, executives lost jobs, and suppliers of credit became even more restrictive. Due to the combined effect of losing equity to writedowns and having to take SIV debt onto balance sheets, there was **talk of bank equity capital becoming inadequate**. Citigroup found it appropriate to sell convertible equity to Abu Dhabi with an 11% starting dividend, and others like UBS and Merrill Lynch followed suit.

- Mortgage lending ground to a near halt, even for "prime" borrowers. Homebuilders and housing-related retailers issued profit warnings. Inventories of unsold homes swelled. A few money market funds threatened to "break the buck" and had to be rescued. Towns in Norway that had bought CDO debt neared insolvency. Florida's pooled fund for localities had to suspend withdrawals. Mono-line insurers that had guaranteed mortgage-related securities came under pressure, casting doubt on the safety of municipal bonds they had insured. **The "isolated development" had sprouted surprising and widespread repercussions.**

In just four months – from mid-July to mid-November – we saw the development of a full-fledged credit crunch, with that term regularly appearing in the headlines. Whereas anyone could get money for any purpose a year earlier, now deserving borrowers had a tough time securing funds.

And there you have it: five pages devoted to the past in a memo about the future.

<u>Clouds on the Horizon</u>

The Fed and other central banks have taken strong action to lower the cost of credit and inject reserves into the system. And in the last month or so, things went quiet. But with everyone back from the holidays, events are likely to heat up again.

Clearly things have just begun to be sorted out in the financial sector. Year-end pricing of mortgage-related securities may bring further writedowns. Auditors may view low prices as more defensible than high ones, and avoiding legal risk can influence their decisions. Conservative auditors will do battle with bank managements desirous of maintaining equity reserves and financial flexibility. On the other hand, there may be a wish on the part of managements – especially new ones – to clear the decks by marking down or selling off problem assets. All of this may result in bigger losses in the short run.

There's still some mystery about whether mortgage losses will pop up in new places. For example, relatively little has been reported by insurance companies and pension funds. We also thought Asian institutions were big buyers of CDO paper over the past year or two, yet nothing's been heard from them to date.

Fundamentals are really bad in the housing sector: Record home price declines. High levels of foreclosure, and neighborhoods where for-sale signs are everywhere. Swollen inventories of unsold homes. Mortgage interest rate resets that are likely to add further to the above. Very low sale volumes (meaning sellers haven't adjusted to reality in terms of the prices it'll take to tempt buyers). Financing and refinancing difficult to obtain. People unable to buy homes because they can't sell the ones they own.

What will happen to mortgage defaults? It's hard to say how bad it'll get. Anyone who bought a home in 2005-07 and borrowed a high percentage of the cost is likely to be "upside-down" – that is, to owe more on the mortgage than the house is worth. Will these people keep on making mortgage payments? And what will happen as interest rates reset from teaser to market? Will borrowers be able to afford the increased payments? Will they stop paying on car loans and credit cards to make the mortgage payment? Or are the former more essential for survival in the short run?

Implications for the Broader Economy

Everyone wants to know whether there's a recession ahead. They're even asking me . . . someone who certainly doesn't know.

I don't think about it much. First of all, thinking isn't going to produce a useful answer. People have opinions, and while they may be considered opinions, I wouldn't bet on whether they'll be right. Most people say the probability is about 40-50%, which I think is their way of saying they don't know but they feel it's not unlikely.

A recession is a technical matter: two consecutive quarters of negative real growth. Sure, recessions are bad, but if there isn't a recession, that doesn't mean everything's okay. **What matters to us is whether the economy will or won't be sluggish. It is generally believed that highly leveraged companies run into trouble and defaults rise significantly when economic growth falls below 2% per annum.**

Several things suggest that in the months and perhaps a year or two ahead, economic growth will be less than vibrant. Many are related to the consumer. The housing situation described above particularly bodes ill.

- Rising mortgage payments are likely to hinder consumer spending.
- It's hard to believe consumer psychology will be positive. With home prices well below the levels of a year or two ago, the "wealth effect" will be negative. Feeling poorer is likely to discourage consumer spending. So is negative news about the economy, and the receipt of much larger bills for gasoline and heating.
- The combination of rising home prices and generous capital markets in the past permitted home equity to be withdrawn and spent. Neither of those is likely to be a positive in the near future.

Consumer spending is the engine of the U.S. economy's growth. I just don't see it staying strong. I heard the other day that we should applaud consumers' "resilience": their willingness to spend even when incomes and news are negative. Personally, I find it frightening. Eventually there'll be a day of reckoning for spending growth which isn't supported by income growth – that is, for dissaving.

The second element with a negative prognosis is capital availability. Banks' losses on mortgage-related securities have eaten into both (a) the capital they need to support their lending and (b) their appetite for risk. Less credit is available to hedge funds and private equity funds. Fewer CDOs and CLOs will be formed in the near future, so they won't be able to provide debt capital as aggressively as they did in the past. **Just as leverage and willingness to bear risk were the twin engines of the recent boom, so their reduction is likely to cause things to slow.**

Third, business expansion is unlikely to contribute to growth. Already-slow holiday spending, employment growth and orders for durables are unlikely to encourage businesses to expand production, build inventories or create jobs. The announcement of corporations' fourth quarter results in a month or so will give us a hint regarding direction.

The main offset to concern about a slowdown comes from overseas. In the past, a recession in the U.S. was sure to have effects worldwide. Now, it seems possible that developing economies such as those of China and India will see enough demand from elsewhere – including domestic demand – to avoid importing our slowdown. The most optimistic case holds that foreign demand might avert a recession in the U.S. Such demand could be buttressed by the softness of the dollar, which makes our goods very attractive to buyers spending foreign currencies. We'll see.

As usual, there are optimists and pessimists. The optimists see enough strength to offset the effect of the mortgage losses. The pessimists think a massive contraction in the prices of assets – mostly homes – implies a calamitous contraction that can only be averted through massive government action (if at all). We won't bet on which is right, but we believe the economy – and thus business – will be less vibrant in the period ahead than it has been.

The Fed's Dilemma

Investors are hoping the Fed will ride to the rescue with rate cuts and capital injections that bolster the economy. It did so in September, allowing sentiment to improve and debt prices to recover for a while, and again in December.

The markets rejoice when the Fed cuts rates (all but the bond market, which worries that rekindled inflation will push up interest rates, which will push down bond prices). Personally, I think a rate cut sends a mixed message. It implies help is on the way, but it makes me wonder about the peril that made the Fed take the step. It's like the guy who goes to the doctor and sees him pull out a gigantic hypodermic. Nice to know he's getting treatment, but isn't the condition worrisome? Along those lines, the Fed's 50 basis point cut on September 14, which exceeded most expectations, caused *breakingviews.com* to run the headline "Does Ben [Bernanke] know something we don't?"

Around November 27, investors concluded they could count on a significant rate cut, causing the Dow to move up 546 points in just the next two days. Surely they think lower rates will stimulate the economy and help offset the credit crunch. But here are the counters:

- **Will making money cheaper cause financial institutions to borrow and lend, or people to borrow and spend?** Can a rate cut offset the frightening aspects of declining creditworthiness? Low interest costs provide scant compensation when loans go unpaid. Thus the Fed can offer cheap money, but it can't make people borrow it, spend it or risk it. The phrase for that problem is "pushing on a string." It's a big part of the reason why Japanese economic growth has never been successfully restarted. For this reason, some observers are suggesting that Washington add fiscal stimulus (tax cuts and spending increases) to the Fed's monetary policy. In this way, consumers' reticence can be offset by direct government spending.

- **Will fear of rising inflation deter the Fed from stimulative action?** In general, central bankers view their primary job as keeping inflation from accelerating as the economy grows. Avoiding slowdowns is usually secondary. Prices are moving up sharply in food and fuel, and the overall rate of inflation has broken out from the low levels of the past decade. This may limit the Fed's freedom to stimulate the economy and risk a reheating. And I hear some worry about a return to the "stagflation" of the 1970s, in which inflation roared ahead but economic growth couldn't gain traction.

- **What will lower rates do to the willingness of foreigners to hold dollar reserves?** We need foreigners to hold dollar-denominated securities. They're the swing buyers of billions of dollars of Treasury securities each year. If they won't do so, who'll finance our fiscal and trade deficits? If investing at U.S. interest rates is seen as implying too great an opportunity cost, a spreading conclusion that dollar holdings are unattractive will put us in quite a financing pickle. Of course, this worry will be ameliorated if there's widespread rate cutting among the central banks of the developed world.

- **Finally, the Fed has to think about moral hazard**. Yes, the Fed wants to prevent financial catastrophes and widespread resulting pain. But at the same time, it doesn't want to give risk takers the impression that they can count on the central bank to make them whole, and thus encourage greater adventurousness in the future. The Fed will have to balance its reluctance to rescue sophisticated speculators against its desire to protect "innocent bystanders."

I'm sure the Fed will take strong steps to keep the credit crunch from becoming as bad as it otherwise might. But there are limits on its freedom to take action and its ability to save the day.

Averting Fire Sales

Many of the full-blown crises I've seen have been caused (or exacerbated) by the following process, which eventually ends in something commonly called a fire sale:

- take on short-term capital,
- invest it in longer-term or illiquid assets,
- experience price declines and writedowns that eliminate your resolve to hold, unsettle your suppliers of capital and/or jeopardize your capital adequacy,
- receive a margin call or capital withdrawal notice,
- need to raise cash on a day of market chaos, and
- be forced to sell into an inhospitable market regardless of price.

In the distressed debt funds that we organized in 1990 and 2002, both times of chaos in financial markets, we earned net IRRs in the 30s and 40s. If you think about it, those IRRs have to be described as aberrant. No one should be able to earn returns like those without significant leverage. And yet we did. Like all active investors, we try to buy things for less than they're worth. **The above results suggest we were aided in those funds by people who were willing to sell things far below their worth.** Why would they do so? Often because of the fire sale process described above.

Not surprisingly, our financial leaders are attempting to short-circuit this process. Mortgage defaults are real and widespread and will produce losses for holders of related securities. Eventually those losses will have to be recognized and dealt with. But I think several of the actions we're seeing are aimed at avoiding exaggerated, panicked fire sales:

- injections of liquidity,
- mortgage reset holiday,
- taking SIVs (and their debt) onto balance sheets, and
- proposing a Super-SIV (which now seems to be history).

But we need to recognize that in addition to potentially enriching buyers of distressed assets, fire sales clear problems from balance sheets and speed solutions. They bring pain and chaos, but they also move things ahead. One of the reasons for Japan's lingering malaise may be that it denied its bad-debt problems for too long, allowing sluggishness to dominate the economy. The questions in the U.S. and Europe will be what's being done and whether it will work.

I looked at the Super-SIV particularly quizzically. Its avowed purpose was to prevent fire sales on the part of SIVs that had financed debt purchases with asset-backed commercial paper that couldn't be rolled over. So financial institutions would fund an entity that would buy assets rather than require their sale in the open market, where they would bring lower prices. But that's perverting economics! Let's see: "We'll buy something for 90 rather than see it come to a frozen market where it might bring 70. Yes, we'll buy it now even though we might have gotten a chance later to buy it for less." That just shouldn't happen, and now it appears it won't, as the Super-SIV mission has been scrubbed.

A Word on the Monoline Insurers

I usually emphasize discussion of macro developments, but at this time there's a micro story that very much deserves telling. Over the last two decades, a few companies developed the business of insuring municipal bonds. Since this was their only business, they're called monoline insurers. Because of the extremely low historic frequency of defaults on munis, a relatively small amount of capital was enough to allow MBIA, Ambac and a handful of smaller companies to guarantee the payments on $2 trillion of municipal bonds.

In the last few years, rather than be left behind as old fogeys, these companies "got modern" like almost everyone else: in addition to munis, they began to insure leveraged entities such as CDOs. And like everyone else, the actuarial calculations they used to determine how much debt they could afford to insure and the premiums they should charge were based on default experience from a brief period that shouldn't have been extrapolated. Thus, like so many others, they took on propositions that have trashed their balance sheets, with grave implications for their basic business.

Here's where it gets interesting. Many muni buyers either want or are required to hold only AAA-rated bonds. And many munis gained their AAA ratings not because the issuers were eminently creditworthy, but because they were insured by companies with AAA ratings. But several of the insurers have landed on the credit rating agencies' watchlists for downgrades, given the possibly unknowable risks they assumed. **If they lose their AAA ratings – and thus the bonds they insured do so as well – will there be a rush of muni holders to the exit? A fire sale at which buyers are scarce?**

One or more of the insurers may need injections of equity capital to bolster their reserves. But what price will investors pay for their stock? (Warburg Pincus committed to invest in MBIA about a month ago, when the stock was at $31, and today it's less than half that). And if the potential CDO losses are so great that a monoline insurer's net worth may be negative on an expected value basis, would anyone put in equity capital when the first of it basically will go to cover creditors? Certainly the monolines' future has been complicated by Warren Buffett's decision to compete by forming a new company that's not burdened by a CDO legacy.

A relatively minor sideshow, but one very much worth watching. And one which illustrates the potential of "isolated developments" to have surprisingly widespread ramifications.

<u>The Shoe That Hasn't Dropped</u>

Amid all the chaos, one area has been unaffected thus far: corporate credit-worthiness. Defaults on high yield bonds and non-investment-grade loans are usually the site of most of the pain in this area, and to date there have been almost none.

Defaults among high yield bonds have averaged 4.2% over the last 20+ years and reached double digits in 1990-91 and 2001-02, giving us huge opportunities to buy depressed assets. In contrast, over the last year or two defaults have been near 25-year lows . . . and practically zero. Oaktree's high yield bond portfolios are in their 47th month without a default. Will default rates on high yield bonds reach or exceed the historic average? And how will the new asset class of leveraged loans weather its first test?

First, with a **slower economy**, there's every reason to believe creditworthiness will decline and defaults will rise. It's just hard to believe that the incidence of default will be unaffected if the economic environment turns less salutary.

Second, over the last few years we've seen **a highly elevated level of buyout activity**, with deals priced at increasing multiples of cash flow and financed with rising proportions of debt. Better companies can support higher debt levels, and some of the buyouts have been of top companies. But we feel that prices and leverage ratios have been high in the absolute, and that competition to buy companies in a heated environment made buyout funds stretch on purchase price. **Some of the assumptions underlying these deals undoubtedly will prove to have been overly optimistic**, and eventually we'll have the opportunity to buy debt in those deals at discounts.

Non-performing debt related to leveraged buyouts gave us great buying opportunities when the LBOs of the 1980s cratered in 1990. Chastened providers of capital cut back their lending in the 1990s, and thus buyouts didn't contribute to the 2002 debt crisis. But we expect unsuccessful buyouts to be a primary source of distressed opportunities in the next go-round. Given the high volume of non-investment-grade debt issuance recently, even a moderate rate of default implies a heavy supply of distressed debt, contributing to the perception of a credit meltdown.

Third, lots of potential defaults will be delayed or prevented because recent issuance has emphasized **issuer-friendly debt**. Default occurs when an interest payment isn't made or a debt covenant (non-cash financial requirement) is breached. But in some recent issues, the borrowers obtained the right to pay interest for a while in the form of additional debt ("toggle" bonds, because the borrower can throw the switch), and in some there were few if any maintenance covenants ("covenant-lite" debt). Some borrowers also arranged for standby credit facilities, giving them further financial flexibility in tough times. Fewer tripwires – fewer defaults. These features will delay defaults but won't necessarily preclude them. It all depends on what happens in the period between the day the default otherwise would have occurred and the day the music has to be faced. Maybe there'll be fewer defaults. Maybe bigger ones. And anyway, there's lots of "normal" (non-issuer-friendly) debt outstanding, especially in connection with small- and mid-size buyouts.

In addition, it's not as if debt became more borrower-friendly without there being a response. **Financial engineers, who decide what risks can be taken on the basis of what's likely, don't see risk decline and leave it at that. They tend to build back the risk so as to fully utilize their "risk budget."** So I imagine people said, "Debt has become easier to bear; let's take on more of it." Which is safer: a company with a moderate amount of demanding debt, or one which has been highly levered with debt that's less burdensome? The answer is that you can't tell without knowing how things will unfold. You certainly can't say the latter company is less risky than the former.

Buyouts in **Europe** have been at least as aggressive as in the U.S. and on average have been associated with less solid companies. In addition, Europe has never seen a full-fledged debt crisis, and the first one could be traumatic. Thus we expect numerous defaults and lots of discounted debt there. On the other hand, **Asia** hasn't yet been the site of many highly leveraged buyouts, so high levels of defaults and distress don't figure into our expectations for Asia. Maybe next cycle, after some aggressive buyouts have taken place there.

Looking ahead, private equity will be subject to crosscurrents. The less accommodating capital markets will have a number of effects:

- Buyout funds will find it harder to finance acquisitions, especially large ones.
- Similarly, a lot of existing buyout debt won't be refinanceable on the same terms in the new environment.
- The speed and ease of recaps will be reduced, rendering quick withdrawals of equity capital at ultra-high IRRs much less likely.
- It will be harder for funds to achieve profitable exits, as would-be buyers from private equity funds won't find it as easy to finance purchases or pay high prices, and IPOs will be an uncertain route to realizations.
- But these same factors will also affect the competition to invest, meaning private equity funds' purchase prices in the future will likely be lower than they otherwise would have been.

Finally, underperforming companies will crop up in private equity portfolios, and the need for turnarounds and restructurings will take up time and pull down returns.

In many ways, the private equity industry may have to operate as it did in an earlier era, when funds were smaller, the volume of transactions was more moderate, both purchase and sale prices were lower, holding periods were longer, and IRRs were lower (but perhaps more meaningful in terms of times-capital-returned). Funds will have to make money the way they used to, with more emphasis on buying cheap and adding value and less on financial engineering and quick flips. Large funds formed within the last 12-18 months may find themselves uninvested for a while, and thus in high-fee limbo.

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It's worth remembering that the boom of the last few years arose in the financial sector, not the "real world." Economies grew around the world – as did corporate profits – but there was no economic boom other than in developing nations. **It was optimism, risk tolerance, innovation, liquidity, leverage, credulity and the race to compete that reached multi-generational highs. Thus the ramifications will be (actually, have been) felt first and most strongly in the financial sector. The question is how far they'll spread from there**.

Undoubtedly, credit will be harder to obtain. Economic growth will slow: the question is whether it will remain slightly positive or go negative, satisfying the requirement for the label "recession." Regardless, positive thinking and thus risk taking are likely to be diminished. All I can say for sure is that the world will be less rosy in financial terms, and results are likely to be less positive than they otherwise would have been. That can be enough to make highly leveraged transactions falter.

I've said many times that for each period there's a mistake waiting to be made. Sometimes it's buying too much, and sometimes it's buying too little. Sometimes it's being too aggressive, and sometimes it's not being aggressive enough. Which it is depends on the combination of the going-in opportunities and the environment that unfolds.

What mistake is on offer today? How aggressive should one be? **Although the extent of the coming softness has yet to be fully defined, I feel we're in the second or third inning.** (For readers who aren't followers of baseball, that means the standard nine-inning game has barely begun.) I recently read a piece asserting that we're still singing the national anthem before the start of a game destined to go beyond nine innings, but I find it hard to engage in such extreme thinking. The damage has begun to be felt and the correction has begun to take place.

Nevertheless, I do think we're in the early going: the pain of price declines hasn't been felt in full (other than perhaps in the mortgage sector), and it's too soon to be aggressive. Things are somewhat cheaper (e.g., yield spreads on high yield bonds went from all-time lows in June to "normal" in November) but not yet on the bargain counter. **Thus, I'd recommend that clients begin to explore possible areas for investment, identify competent managers and take modest action. But still cautiously, and committing a fraction of their reserves.**

"Don't try to catch a falling knife." That bit of purported wisdom is being heard a lot nowadays. Like other adages, it can be entirely appropriate in some instances, while in others it's nothing but an excuse for failing to think independently. Yes, it can be dangerous to jump in after the first price decline. But it's unprofessional to hang back and refuse to buy when asset prices have fallen greatly, just because it's less scary to "wait for the dust to settle." It's not easy to tell the difference, but that's our job. We've made a lot of money catching falling knives in the last two decades. **Certainly we'll never let that old saw deter us from taking action when our analysis tells us there are bargains to be had.**

In the period leading up to the current crisis, investors acted like they were loaded down with too much cash and desperate to put it to work. To do so, they ventured into uncharted waters and unknowingly accepted high risks in investments providing less-than-commensurate compensation. **With too much money chasing too few deals, the bargaining power was in the hands of the takers of capital.** They used it to their advantage, making deals that were good for them but bad for the suppliers of capital. **In the period ahead, cash will be king**, and those able and willing to provide it will be holding the cards. This is yet another of the standard cyclical reversals, and it will afford bargain hunters a much better time than they had in 2003-07.

Some of those who came to the rescue of troubled financial firms in 2007 may have jumped in too soon. There's a fair chance they didn't allow maximum pain to be felt before acting, (although the prices they paid eventually may turn out to have been attractive). **I'd mostly let things drop in the period just ahead. My view of cycles tells me the correction of past excesses will give us great opportunities to invest over the next year or two.**

January 10, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: Whodunit

> **who·dun·it** – (hōō dun´ it) *n.* a narrative dealing with a murder or a series of murders and the detection of the criminal (The Random House Dictionary of the English Language)

The subprime crisis, credit crunch and possible recession are subjects of daily conversation. In addition to wanting to talk about how things got this way and what's going to happen in the future, a lot of people are eager to discuss who's to blame. It's the purpose of this memo to say where I think responsibility lies.

The Subprime Factory

I've heard it said about laws that, "like sausages, you don't want to see how they're made." I'd like to suggest something else where the manufacturing process was particularly distasteful: subprime mortgages.

This decade's vast expansion of the subprime factory originated in the ability of **Wall Street** to sell a lot of mortgage-related Collateralized Debt Obligations, or CDOs. The high interest rates on subprime mortgages enabled the Street to promise a lot of return on the lower CDO tranches and a lot of safety on the upper ones. With high-enough ratings, the debt looked very attractive to potential buyers. Thus, there was a use for large amounts of the underlying raw material: subprime mortgages. It happened, however, that Wall Street could sell more bologna sandwiches than there was bologna. That is, there was more appetite for securities built from high yielding mortgages than there were qualified borrowers. No problem: just provide incentives to increase production and turn a blind eye to creditworthiness.

Mortgage brokers played an essential and often ugly part in this process. They were tasked with creating mortgages in quantity, and that's where their incentives lay. **Since neither they nor the Wall Street firms would hold the mortgages for long, the emphasis was on volume rather than creditworthiness.** Making loans was good; rejections were bad. The website of broker Kevin Schmidt's firm in Louisiana said it best, "We don't get paid unless we say YES." (*The Wall Street Journal*, January 17) The *Journal* went on to point out that, "Key players often get a cut from what a transaction is supposed to be worth when first structured, not what it actually delivers in the long term."

Thus I believe mortgage brokers committed many sins. They offered more debt than many subprime borrowers could carry. They assured borrowers that they'd always be able to refinance into new loans at teaser rates, so they needn't worry about a reset to market rates. They probably weren't clear on all the terms and practiced the old bait-and-switch. They hid from first-mortgage lenders the fact that borrowers were borrowing their equity too. And I'm sure some encouraged borrowers to lie about their incomes, invoking "Everyone does it," "Why should Joe and Sue have a nicer house than you?" and "Nobody gets hurt."

Appraisers made a similarly negative contribution to the process. In the days when home prices were stable, appraisals were based on established parameters like price per square foot. But with prices rising rapidly, they could only reference "comps" to other highly appreciated homes. **Like the credit rating agencies, appraisers lent a veneer of respectability to a faulty process.** And like rating agencies, the job probably went to the appraiser willing to assign the highest value. I've read about appraisers being black-listed because they were too conservative, restraining loan volume. According to the *L.A. Times* of January 27, a Wharton professor, Susan Wachter, has estimated that "appraisers helped inflate mortgage values by $135 billion during 2006 alone." Borrowers, home sellers, mortgage brokers and Wall Street all had a vested interest in seeing high values assigned. **There's something fundamentally wrong when there's no party to a transaction who wants the appraisal to be conservative.** But that became the case when far-away, ratings-assured buyers of sliced-and-diced mortgage securities took the place of lenders risking their own money and expecting to hold to maturity.

Mortgage insurers played a similar role by lending their imprimatur and thus implying instruments were safe. Everyone thinks of taking out insurance as a cautious thing to do. When risks are insured, the people exposed to them believe they're safe to behave differently than they otherwise would. But what happens when the insurers miscalculate the risks involved, and thus issue more coverage than their capital can support in tough times? In the extreme, losses can go unreimbursed, meaning the insureds don't really have the protection they think they have and their situation is riskier than they intended. **Certainly in this cycle, insufficiently cautious insurers abetted the bearing of risks that have exceeded expectations.**

Let's remember that the **mortgage borrowers** don't deserve a free pass. It was stupidity or cupidity, naïveté or moral turpitude. At best they took on massive financial responsibilities they didn't understand, and at worst they were fraudsters. Many took out "no-doc loans" at interest rates above those charged on loans requiring documentation of income. Why? I assume they wanted to be free to lie. And many agreed to terms they couldn't decipher. But why worry, if the result is a great house at a low initial monthly payment (and maybe cash taken out in the process)? I hate to see the borrowers' suffering, but each one willingly participated in a deal that was too good to be true.

Turning Mortgage Loans into CDOs

CDO investors are in the headlines for having lost $100 billion-plus (thus far) on subprime-related obligations. Someone sold them something that turned out to have been massively overpriced. Thus I have to start with the **investment bankers**. Again, was it naïveté or avarice?

When Oaktree considers a new product, we ask a number of questions: First, will it work for our clients; what's the return potential; and are the risks controllable? And second, can we sell it; and will it be profitable for us? Which of these did Wall Street ask regarding subprime CDOs? The second group of questions undoubtedly, but the results provide no assurance regarding the first. They sold something that failed massively, and they've gotten off somewhat easy in terms of society's judgment. Fittingly, investment banks like Merrill Lynch, Citigroup and UBS ate a lot of their own cooking (and a good part of the losses). But that does not absolve them of responsibility, for others were hurt as well.

I believe firmly in *caveat emptor*, but that doesn't mean there's no such thing as misconduct on the part of sellers. Did they perform thoughtful and balanced due diligence? Did they give enough thought to the buyers' downside risk? Did they suspect that the good deal might be illusory? Did they see the flaws in the mortgage origination process? When they marshaled data with which to prove to customers and rating agencies that CDOs were secure, did they consider the data's sparseness or limited relevance? Did they fail to disclose information regarding the "exceptions" in CDO portfolios – mortgages that didn't meet minimum lending standards – as the New York Attorney General is investigating (*WSJ*, January 31)?

Some of the same questions can be asked about the role of **CDO managers**. I haven't been close to the process – Oaktree didn't have any involvement – but I believe managers met with investment bankers who offered a near-turnkey proposal: "Here's how it works. The documents are ready to go. We have the assets in inventory. The debt is teed up for issuance. Your fees will be x million per billion." Did the managers vet the process? Did they undertake an independent effort to gauge the risks? Or did they just sign on to the magical fee machine?

Next up, in my opinion, are the **credit rating agencies**. In summary, everything was wrong with the process through which CDO debt was rated, a process fed by the agencies' hunger for profit. The agencies worked with CDO sponsors to design the products, so how could they then be objective in evaluating them? They accepted payment from the companies whose offerings they were rating; they all did, but that doesn't mean the arrangement left them objective. They competed for the business, with the fees going to the agency that would assign the highest rating.

But in the end, the rating agencies' greatest failing lay in giving their blessing to securities whose risk they couldn't accurately assess. The eventual default rate was crucial and unknowable. The historic data on subprime defaults related to mortgages that were issued through a far different process and incentive system. But I can't imagine any agency saying, "The risks are unknowable; we just can't assign a rating."

How do we know the agencies bobbled the ball? The **twelve-digit losses** to date give a pretty good indication. An article in *The Wall Street Journal* of January 31 gives another:

> Standard & Poor's downgraded or threatened to downgrade more than 8,000 mortgage investments and projected a widening array of financial institutions would ultimately face mortgage securities losses totaling more than $265 billion. . .
>
> S&P's rating actions touched on $534 billion in mortgage-related investments, including **47%** of the U.S. subprime mortgage bonds rated in 2006 and the first half of 2007. . .
>
> **S&P . . . has now placed 69% of the triple-A rated subprime bonds from 2006 on negative watch**. (emphasis added).

I'd call that a thorough indictment. It indicates a flawed process, not occasional error.

The situation is remarkably similar for the **monoline insurers** . . . but with an added wrinkle. These firms carved out a good but dull and slow-growing business in insuring municipal bonds. Since munis default so infrequently, they needed little in the way of capital to cover potential losses, and they probably started to feel they were pretty good at gauging losses. In the 1990s, they concluded that mortgage-backed securities were no more risky than munis. (Not so, it turns out: MBIA recorded mortgage-related losses of $714 million in the fourth quarter, versus losses of $920 million on munis over its 36-year history, for an average of $26 million a year.) Thus the insurers applied their capital and acumen to insuring $125 billion of CDO debt. They acted out of the same ignorance as the rating agencies, **but they promised to make good on any losses**.

The results are potentially disastrous. Their capital is clearly insufficient to cover their responsibilities. ACA Financial Guaranty Corp., for example, wrote $69 billion of credit protection on the basis of its $425 million of capital. And if CDO losses eat into the monoline insurers' capital and/or cause them to lose their triple-A ratings, it will diminish the reliability of their assurance with regard to $1 trillion-plus of munis they backed. Loss of the triple-A rating would hurt the outstanding insured munis, wreak havoc in the muni market generally, and make it harder for new bonds to be issued, at just the time that cities and states need money to cover economy- and subprime-related revenue declines. Also of critical importance, it will require holders of insured CDO paper to take additional writedowns. The monoline situation has begun to contribute to the credit crisis, and people are scurrying to find a solution (thus far without success).

All the participants in the CDO creation process took part in an activity we can call "ratings arbitrage." If you can take a bunch of assets with low ratings and – without adding to the intrinsic value of the collateral in any way – turn them into securities with much higher average ratings, you can make a lot of money. But the ability to do so means there's something wrong. (In other words, if it's possible to start with 100 pounds of hamburger and end up selling ten pounds of dog food, 40 pounds of sirloin and 50 pounds of filet mignon, the truth-in-labeling rules can't be working.) **In the case of CDOs, ratings and insurance were supplied by parties who underestimated the risk, and the end product was sold – and bought – by people who were willing to participate in this purported miracle without asking the hard questions.**

The Failure of Risk Management

I've long been critical of risk management as a distinct investment discipline. Now, a convincing case for my view can be made on the basis of *prima facie* evidence: The fact that most financial institutions appointed **risk managers** after the collapse of Long-Term Capital Management in 1998 doesn't seem to have helped them avoid the subprime mess.

If you trust someone to be expert enough to make an investment, then that's the person who can best assess its risk. If you trust someone to assemble portfolios, it's they who can best judge how things will behave in combination. In the isolated risk management function, I feel people who know less about the underlying investments second guess the people who know more.

There's an ongoing dilemma, as expressed in a joke I posted on my bulletin board in 1970, about the fact that analysts know a great deal about a few things, while portfolio managers know a little bit about a lot of things. In my view, however, risk managers know the littlest bit about the most things, so they're least suited to evaluate portfolio risk.

In December's "No Different this Time," I included a discussion of the leading risk modeling tool, "value at risk" or VaR, which provides a "worst case" estimate of the risk in a portfolio. I mentioned that in the first nine years after the model was adopted, its predicted maximum trading loss was never exceeded. And then, in the third quarter of 2007, it was exceeded on a quarter of the trading days. So clearly, this model proved to be less than totally reliable. The model may be flawed, the historic data on which it was based may have been non-representative or insufficient, or the world may have changed. Regardless of the reason, VaR failed.

When you read about Goldman Sachs's success in avoiding the CDO turmoil and getting net-short, (see *The Wall Street Journal* of December 14), you see it was done on the basis of the reasoned judgment of executives on its proprietary trading desk. Ironically, when mortgage-related security prices first began to plummet, the increase in volatility raised Goldman's VaR, causing the elimination of positions that eventually would have been highly profitable. According to the *WSJ*, "a client who had similar positions at the time . . . says he made $100 million by relieving Goldman of [a] short bet. 'It appeared to me that [the traders] constantly fought a VaR battle with the firm once the market started to break.'" But in the end, subjective judgment was permitted to override risk management science, with great results.

Interestingly, many banks got into trouble because their top executives wanted to "be like Goldman" and demanded that more be bet for the house's account. But they lacked people capable of correctly making the needed judgments and relied instead on statistical risk managers. They've lost a lot of money, and a lot of the executives and the risk managers are out of a job.

Enough with the Quants Already

Over the forty years since I attended grad school at the University of Chicago – largely inspired by theories originated there – there's been a pronounced rise in the participation of "quants" in the investment business. These are people who know a lot about statistics and computer modeling. They specialize in manipulating large amounts of data and predicting how portfolios are likely to perform under a variety of scenarios. But usually they don't know much about the individual securities that make up the portfolios . . . or feel the need to do so. **In other words, you might say they know the price of everything and the value of nothing.**

In recent years – and in the excesses we're examining – the ranks of quants grew to include the risk managers discussed just above; "financial engineers" at investment banks who structured complex entities and simulated their future performance; analysts at monoline insurers who assessed the risks they were asked to insure; and people who managed portfolios, usually hedge funds, on the basis of mathematical algorithms.

However, it should be noted that **quants and their computer models primarily extrapolate the patterns that have held true in past markets. They can't predict changes in those patterns; they can't anticipate aberrant periods; and thus they generally overestimate the reliability of past norms.**

To give you a context in which to think about that, I'll again borrow some wisdom from my friend Ric Kayne: **"99% of financial history has taken place within two standard deviations," he says, "but everything interesting has taken place outside of two standard deviations."** In other words, most of the time markets follow their normal patterns, and when they do, assets are priced reasonably and there isn't much to do. But on rare occasion, the markets go off the rails, and that's when big money is made and lost.

Now think about the quants. They know all about how things will work if times are normal, but their analysis is of no help when events occur that reside in the far-off, improbable tails of the probability distribution – like when it turns out that 2% isn't the right default rate for subprime mortgages, and the actual figure is several times that.

One of the great investment books of the 1960s was *The Money Game* by the pseudonymous Adam Smith. Smith talked about a veteran investor, the Great Winfield, who knew he was falling behind the times but had the answer: "Our trouble is that we are too old for this market. . . . My solution to the current market: kids." In the last decade or two, everyone hired quantitative whiz kids, and the results were disastrous. **Hopefully, the events of the last few years will produce a sea change, in which investors come to rely more on seasoned judgment and less on financial engineers.**

Greenspan and the Fed

Alan Greenspan deserves a lot of credit for presiding over one of the greatest periods of prosperity and market gains in our history, and for saying, presciently, ". . . history has not dealt kindly with the aftermath of protracted periods of low risk premiums." With apologies to my indirect personal connection to the ex-Fed Chairman, I must express my view that his stewardship wasn't perfect. (Of course, I doubt he'd say it was perfect.)

- Because he rarely used his bully pulpit to warn about excesses, advances were permitted to run unchecked. For example, his warning against "irrational exuberance" attracted a lot of attention, but I've always wondered why, if he considered it justified in 1996 with the Dow at 6,400, we heard nothing from him on the subject in 2000, when it topped out at 11,700. And mightn't he have warned in recent years about overheated home prices and aggressive mortgage lending tactics?

- He did little to "remove the punchbowl," or puncture bubbles. He could have pushed for higher margin requirements in 1998-99, or for mortgage reforms in 2004 or 2005, but he didn't, insisting that it's difficult to identify bubbles other than in hindsight.

- He was too much of a cheerleader, providing justification for market advances, often on the basis of productivity gains.

- In 2004, he urged people to take out adjustable rate mortgages rather than fixed-rate loans, since they always carry the lowest initial interest rate. But he overlooked the fact that (a) low-income borrowers might be ill-equipped to handle the risk of resets to higher rates, and (b) with mortgage rates at multi-generational lows, that would have been a great time for them to fix their interest cost. Just think where we'd be if a good portion of today's adjustable-rate mortgages carried fixed rates instead.

- **Having cut interest rates to head off negative ramifications from the bumps in the road, he left them low for too long. I learned in the hyperinflationary late 1970s and early '80s that when people feel an asset will always appreciate at an annual rate in excess of the cost of money, the result is speculative demand. That certainly was the case this decade.**

In general, it seems the Fed – including the current Bernanke regime – wants to let advances run and limit declines, whether in the economy or the markets. Everyone wants advances and no one – except bargain hunters and investors in distress – relishes pullbacks. But I wonder if that stance makes sense.

How can we have gains but not losses? How can a free-market economy allocate capital effectively if capital creation is abetted and capital destruction is prevented? The fact is, excesses like we've just seen have to be corrected – painfully – and if they aren't, they'll just grow bigger and bigger as the cycles wear on. "Moral hazard" will arise, convincing people that risk takers will always be bailed out, something that's bound to encourage greater risk taking.

The Fed's actions in the current situation have been dramatic:

- an unexpectedly large half-point cut in the discount rate in September,
- strong steps to inject liquidity and encourage borrowing by banks, and
- an unusual ¾-point rate cut on January 21, followed by another ½ point a week later.

In two decades as Fed Chairman, Alan Greenspan was required to deal with the emerging market crisis and meltdown of Long Term Capital Management in 1998; the possibility of a Y2K glitch; the tech stock and broader bear market in 2000-02; the ramifications of the 9/11 attack; and concern over the possibility of deflation. **And yet he never cut rates by ¾ point in one step or by 1-¼ points in just eight days.** Thus Bernanke's actions seem extreme. Is the Fed attempting to prevent a normal recession? Does it foresee an unusually serious one, perhaps driven by unprecedented weakness in home prices? Or is it concerned about profound financial system weakness, centered at banks and the monoline insurers?

<u>Kudos and Brickbats</u>

I hesitate to single out an individual for criticism, especially after he's been punished through loss of his job, but CEO **Chuck Prince of Citigroup** contributed the unfortunate quote that just has to stand as the symbol of the last few years' excesses. In early July, he showed foresight by saying "when the music stops, in terms of liquidity, things will get complicated." Unfortunately, he added, **"as long as the music is playing, you've got to get up and dance. We're still dancing."**

What I think Prince was saying is that even if the market's overheated, a financial institution has to participate or risk losing market share to those who will. But that's my point. **Is there any business a company won't do? Is there any profit a company won't pursue? Might there be something worse than losing market share?** What a wonderful thing it would have been to lose market share in the crazy period leading up to last summer. Doing so held the key to avoiding the CDO carnage. **Short-termism is one of the greatest problems in U.S. business today, and it makes it tough to go left when all your competitors are going right. But our business leaders should dare to be great.**

Bank of America CEO Ken Lewis won my respect early last year when he said, "We are close to a time when we'll look back and say we did some stupid things . . . We need a little more sanity in a period in which everyone feels invincible and thinks this is different." He was dead right. The question is what he did about it. B of A took a $5.4 billion write-down in the fourth quarter and has $12 billion of CDO exposure left. Those numbers are about a third of Citigroup's. Is that good or bad?

Who else saw what was coming?

- **Jim Grant** was very outspoken about CDO excesses in his newsletter, "Grant's Interest Rate Observer," and early enough for heedful investors to have done something about it. He was one of the first, for example, to question the fact that most of the collateral behind CDOs was rated below investment grade, and yet a vast majority of CDO debt was rated above investment grade.

- **William Conway** of Carlyle Group attracted a lot of attention – but perhaps not all he deserved – for a January 2007 memo to his Carlyle colleagues, in which he wrote:

    As you all know (I hope), the fabulous profits that we have been able to generate for our limited partners are not solely a function of our investment genius, but have resulted in large part from a great market and the availability of enormous amounts of cheap debt. . . . Frankly, there is so much liquidity in the world financial system, that lenders (even "our" lenders) are making very risky credit decisions. . . . I know that this liquidity environment cannot go on forever. . . . I know that the longer it lasts, the greater the pressures will be on all of us to take advantage of this liquidity. And I know that the longer it lasts, the worse it will be when it ends.

- **John Paulson** won well-deserved fame for generating returns up to 590% in his hedge funds last year. He did three things well: He recognized the excesses in the residential real estate arena. He figured out how to profit from their inevitable reversal. And he was lucky enough to get the timing right; rather than reach his conclusion earlier, look wrong for a long time and give up – as others did – he turned bearish in 2005 and was able to hold on until events began to prove him right in 2006.

- I'm glad to say **our clients' sectors of the investment world** – such as pension and endowment funds and insurance companies – generally haven't reported much participation in the most highly leveraged entities.

- **Goldman Sachs** has distinguished itself thus far by avoiding subprime and CDO losses, being short mortgage paper and skating through the crisis. **Lehman Brothers, Credit Suisse, Deutsche Bank** and **JP Morgan Chase** are other institutions that seem to have signed on for less subprime pain than their competitors.

Finally, a statement by the Chief Executive of **UBS** provided another insight into the recent events. Early last December, he said, "the ultimate value of our subprime holdings . . . remains unknowable." I admire his candor, and I'm sure he's right. But the question I'm left with is whether it might have been possible for buyers of subprime-related paper to reach that realization at the time they first evaluated those assets?

Where Does the Buck Stop?

In affixing ultimate responsibility for losing investments, I tend to look to the investors who made them. Sometimes investors are blind-sided by unforeseeable events, and sometimes they're preyed upon by unethical or even criminal purveyors. **But usually the process couldn't have gone as far as it did if it wasn't for buyers who sought return too avidly, trusted too much, failed in some way to be alert to the potential for loss, and fell for something that was too good to be true.**

Everyone dreams of return without high risk. But where can it be found? Not in markets that are working properly – that is, markets that are efficient. Not in leverage, which should be expected to cut both ways, magnifying both risk as well as return. Not in doing what everyone else is doing, or in buying the product *du jour* that's being touted broadly and purchased unquestioningly. At best it can be found, with regard to markets that are less than fully efficient, in possessing – or aligning yourself with investors who possess – that scarce attribute: personal skill . . . superior insight . . . alpha.

To fully understand how superior returns are achieved and why they're rare, you have to grasp the concept of "excess return." It's what everyone wants. It's "superior risk-adjusted return": the amount by which an active investor's return exceeds that which can be achieved through a passive portfolio of the same riskiness. **For active investing to work and for excess return to exist, market participants – and thus, collectively, the market – have to be making mistakes. That's how I think of the thing called "market inefficiency."** Thus, people who think excess return is readily available fail to ask a few simple questions:

- Why should a free lunch exist despite the presence of thousands of investors who're ready and willing to bid up the price of anything that's too cheap?
- Why is the seller of the asset willing to part with it at a price from which it'll give me an excessive return? Do I really know more about the asset than he does?
- If it's such a great proposition, why hasn't someone else snapped it up?
- Why is the broker offering it to me (rather than grabbing it for his prop desk)?
- **And if the return appears so generous in proportion to the risk, might I be overlooking some hidden risk?**

How do the CDO buyers measure up in this regard? I'd guess they were told they could get better returns from a double-A mortgage security than a double-A corporate without any incremental risk (or else leveraging up wouldn't have seemed so safe). I believe they were told the source of this return would be the market, as opposed to great skill on the part of CDO managers. I imagine they relied heavily on the participation of the rating agencies and monoline insurers. Each of these was flawed.

What made them believe that mortgage loans could be bought up and packaged into CDO securities (with multiple fees paid along the way) with the resulting return still excessive? Why should one legitimate double-A significantly out-yield another? Why didn't they ask more about the process through which this miracle was being accomplished? Why did they accept that narrow spreads could safely be turned into generous returns through leverage? Why did they trust so heavily in the simulated performance of securities for which the existing track record wasn't applicable? Did they look into the motivation and capabilities of the rating agencies and insurers on which they depended? **In short, were they skeptical enough?**

Many CDO buyers had no independent ability to assess the risks of CDOs. But they bought anyway. They followed their desire for high risk-adjusted returns, took action based on the relationship between promised return and rating, and went astray.

The bottom line of all of this is that one of the main functions of markets is to drive out excess return by bringing buyers and sellers together at prices from which the return will be just fair. Realizing that makes skepticism an indispensable ingredient in superior investing. Most investment failures are preceded by a dearth of it.

* * *

I often think back to an early 1990s issue of *Forbes* on the subject of compensation. It quoted an experienced corporate director as saying something like, "I've given up on trying to get people to do what I tell them to do. They do what I pay them to do."

It's clear that in recent years, improper incentives caused a lot of people to do the wrong thing. Loan originators with nothing riding on the loans' long-term performance. Investment bankers who expected to package and resell loans before they went bad. Rating agencies and appraisers – the investor's protectors – incentivized to come in high. Companies that (a) were lured by potential profit into areas where there was no way to understand what would happen in tough times, and thus (b) accepted risks for which they were unprepared. Financial institutions that failed to sit out when the markets became overheated.

My wife Nancy says she likes this memo more than most, because the lesson is so easy to understand. **"People can't be counted on to do the right thing," she said, "when they don't have anything at risk."**

Far more participants in this process covered themselves with dishonor than with distinction, as attested to by the magnitude and ubiquitousness of the losses. But the blame for the current problems falls primarily on two groups, and there's nothing new about either:

- middlemen who were improperly motivated by the ability to profit from actions for which they wouldn't remain responsible, and
- buyers who believed too readily that return was available without proportionate risk and thus were willing to buy things they didn't understand.

Errors in process, judgment and character like those of the last few years cannot be kept from occurring. All any of us can do is try to avoid joining in.

February 20, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Tide Goes Out

For every period, there's a quotation which serves perfectly to explain what's going on, and I often find myself borrowing it. Warren Buffett provides more than his share; not only is his insight unmatched, but so is his ability to express it. Thus, starting with "It's All Good" last July, I've found frequent use for this one:

> When the tide goes out, we find out who's been swimming without a bathing suit.

Certainly, "swimming without a bathing suit" – or perhaps a life preserver – serves beautifully to describe investor behavior during the carefree period that ended last summer. And equally, the ebbing of the tide – and the exposing of those who engaged in that behavior – sums up the unpleasant disclosures which have taken place since. Financial sector participants indulged in unprecedented amounts of leverage, innovation and risk taking between late 2002 and mid-2007, the consequences of which have become readily apparent.

Leveraging and Inflating

When we look at the last few years, we see a rather ordinary period of economic growth and prosperity, accompanied by good corporate health and profitability. **But what distinguished this period from all others was a runaway boom in financial sector activity.** The whole financial sector inflated, like a balloon into which increasingly more hot air was forced.

The greatest contributor to the 2002-07 boom likely was leverage; the recent past saw a steady flow of equity capital to levered entities, accompanied by willingness on the part of lenders to provide unprecedented amounts of leverage. Now the reversal of that process is underway, with consequences that are equally dramatic but much less pleasant.

Let's review the process which was often described and embraced as a virtuous circle:

- Equity capital was provided to would-be leveraged entities.
- Debt was readily available for them to use in expanding their total capital and thus their ability to pursue profit.
- This combined capital was used to purchase assets, forcing prices higher.
- Price appreciation caused the entities' equity to expand at a faster rate thanks to their financial leverage.

- The increases in equity were matched by further increases in borrowings.
- In fact, the good performance convinced lenders to increase the amount of leverage they would supply per dollar of equity. This meant the entities could grow their portfolios even faster than the rates at which equity capital flowed in and assets appreciated.
- Further, because of the seeming impregnability of the leveraged entities' profitability, risk aversion shrank and the risk premiums and returns demanded by lenders declined. Leverage became cheaper and thus even more attractive.
- As is typical of virtuous circles, everything ran smoothly . . . for a while: additional equity flowed in; it was leveraged up increasingly; buying caused assets to appreciate further; and the upward spiral continued.

With things working increasingly well and investors becoming more and more excited, processes like this one seem destined to go on forever. Of course, they cannot. But people forget that, satisfying one of the key prerequisites for a cycle that goes to excess. Overestimating the longevity of up legs and down legs is one of the mistakes that investors insist on repeating.

Deleveraging and Deflating

Over the years I've written a number of memos about cycles, and in each one I've tried to remind readers that trees don't grow to the sky, and that success carries within itself the seeds of failure. Just as the balloon of levered entities expanded beyond reason in the last few years, now it's well into the process of deflating. And, as I mentioned in "Now What?" the air always goes out a lot faster than it went in.

Eventually, developments that are exogenous to the process interfere, or perhaps the process collapses of its own weight. In the current instance, consider subprime mortgages. The process described above was going along just fine, with increasing numbers of ever-larger mortgages being granted to cover a rising percentage of the cost of houses bought at rising prices by borrowers of declining creditworthiness. So far, so good: a process unhampered by discipline or restraint. But it must be seen that, eventually, reality will intrude. For example, eventually the amounts borrowed will necessitate payments that exceed what the borrowers can afford. **Oops; investors forgot that part.**

To understand what's going on now, all you have to do is reverse the process described above and squeeze (the squeeze – the force behind the deflating – comes from the pain that accompanies disclosure of the process's flaws).

- Something causes asset prices to weaken.
- Now the leverage works in reverse, causing the entities' equity to shrink faster than the rate of decline in asset prices, and their ratios of borrowings to assets to rise.
- Lenders, worried about declining asset prices, either call in their loans or refuse to roll over debt when it matures. In some cases, the entities' now-shrunken collateral fails a

market value test and triggers a margin call, which can be met only through the posting of additional collateral (which usually isn't available) or sales of assets (which add to market weakness).

- Further, with the world suddenly feeling much riskier, lenders demand increased risk premiums, raising the cost of borrowed funds and further impairing borrowers' economics.
- Equity investors – panicked by the combination of asset price declines, leveraged equity losses and margin calls – withdraw equity capital to the extent they can. The sight of investors lining up at the withdrawal window, and often being told they can't have their money, adds to the negative climate.
- The need to raise cash with which to satisfy the demands of lenders and equity investors places further downward pressure on asset prices, reinforcing what is suddenly a vicious circle. Fire sales of collateral add to this pressure.
- In particular, think what happens to banks. In this negative environment, it's hard to imagine these highly leveraged entities extending credit, given that (a) banks' equity is shrinking, (b) they feel they may need the money themselves, and (c) they fear further losses on loans and assets.

It shouldn't come as a surprise that this vicious circle seems as obvious and inescapable as did the virtuous one just a short time earlier. This is the point at which we may start to hear talk about the unstoppable downward spiral and thus the pending collapse of the financial system. **Unquestioning euphoria gives way to full-blown depression.**

<u>Mark-to-Market Accounting</u>

If you watch enough cop shows on TV, you know that investigators of suspicious fires use the term "accelerant" for the chemical used by an arsonist to encourage the spread of a blaze. The current capital market cycle has been accelerated by an element that was added to the capital market equation in the 1990s: mark-to-market accounting.

In the simpler but still not totally stable financial world I entered forty years ago, stability was desired in financial institutions. So, for example, banks and insurance companies were allowed to carry a loan or a bond at cost on their balance sheets as long as it was (a) fundamentally unimpaired and (b) intended to be held to maturity. Even if its market value fell temporarily, it was assumed that a creditworthy claim would be repaid in full at maturity. Thus, price fluctuations were ignored as long as fundamentals were sound.

More recently, "transparency," "accountability" and "market signals" became more highly prized. A lot of this had to do with skullduggery unearthed at companies like Enron. As a result, accounting increasingly came to require that assets be valued at actual or estimated market prices. I'd had a preview of this in 1990 when, as part of efforts to "get" the high yield bond industry (and Drexel and Milken), S&Ls were required to market price their holdings of high yield bonds – dooming many of them in a time of price weakness.

There is no perfect accounting standard – just choices, with each alternative stronger on some desired traits but weaker on others. "Cost" is objective but often out of date and far from accurate. "Lower-of-cost-or-market" is conservative but asymmetrical in its error. "Market value" is contemporary but not always reliable; it discloses value declines faster than Enron did, but it also requires subjective judgments and bakes in price fluctuations that may prove transitory. **So when accounting regulators mandated mark-to-market, they decided in favor of currentness and transparency but against stability with regard to marketable securities and objectiveness with regard to privates**.

(When we began to organize closed-end funds in 1988, and for about fifteen years thereafter, Bruce and I established a policy for valuing privates based on "cost unless there's been a change which is fundamental, material and permanent." We felt it served us well. But since Enron and Sarbanes-Oxley, we've been forbidden to use that approach. Now funds are required to price each asset based on opinions regarding its worth. We preferred the old way. Who's better served now?)

Mark-to-market accounting turns out to be one of the main contributors to the current boom/bust cycle. In the old days, a bank (for example) would have carried assets at cost. In this decade's up years, since that bank was required to mark them to market, it was able to expand its balance sheet, and thus its operations, as assets appreciated in the virtuous circle. Equally, contracting asset values now mean the bank's portfolio is worth less, and that its equity is smaller and can support less debt and thus less lending. Loan portfolios have to be reduced, and new loans can't be made. A bank's regulatory capital can become insufficient; it's this, in part, that has been behind the banks' trips to sovereign wealth funds for re-equitization.

Since they operate in a world that combines rigid regulatory capital requirements, high leverage, fluctuating asset prices and, now, mark-to-market accounting, financial institutions can fail to be viable in extreme bear markets. (And as *The Wall Street Journal* of March 6 said, "What's the difference between a hedge fund and a bank? Banks are more highly leveraged.")

In 1990, when high yield bonds had the brush with difficulty described above (meaning spreads widened to 1,100 basis points, and a law was passed that required S&Ls to reflect price declines on their balance sheets), I was asked to brief the board of TCW on the risks. I presented a parable about a regulated financial institution that went bankrupt under the weight of mark-to-market accounting. I joked with Bill Spencer, who was president of Citibank when I worked there, that in the 1980s, that could have been Citibank if it was required to recognize mark-to-market losses on real estate loans. **Guess what: today that's the rule.**

This raises one of my favorite questions: **what's an asset's price?**

- Is it what you could get for it if you wanted to sell it?
- Is it what you would have to pay to buy it?
- Is it the price to buy or sell $1 million worth, or $100 million worth?

- Is it the likely proceeds from the patient sale of an asset in isolation, or what you'd get for it as part of a large portfolio that has to be liquidated in one day?
- Is it the price in today's chaotic market, or what the price would be in a calmer one? And if the latter, who says what that is?
- Is it Goldman's price or Morgan's? Or the average of the two? And what if you find out that Lehman's is lower than both of them?
- What's the price if the asset doesn't trade? Or if you hold the whole thing and have no intention to sell?

I don't have the answer. Mainly because there is no answer. In short, an asset doesn't have "a price." It has many possible prices, and no one can say which is the right one. The ads for a jeweler here in Los Angeles lead with a great headline: "guaranteed to appraise for more." In other words, either (a) he sells jewelry for less than it's worth (and, if so, why?), or (b) he sells things for what they're worth but guarantees they'll appraise for more, which makes you wonder about the appraisals. The way I see it, the appraisals he touts are just as meaningless as many of the "market prices" being used today to price assets at banks, hedge funds, CDOs and CLOs.

A view has begun to be expressed that mark-to-market accounting – in conjunction with the vicious circle that prevails today – is causing asset values to be understated, writeoffs to be overstated, and the credit crisis to be exaggerated. Certainly there's every reason to believe that:

- Assets are being valued based on what people will pay for them (which is the goal), but with few people in a buying mood, market prices can far understate value.
- Supply and demand have completely supplanted fundamentals in determining prices.
- With little trading taking place, assets are often priced via reference to indices. But those indices fluctuate wildly in connection with speculation and hedging activity, and they may have little relevance to the individual asset being priced.
- Lenders are switching their valuations of collateral from going concern basis to liquidation basis.
- Margin calls are resulting in liquidations, which depress prices, leading to more margin calls.

It's hard to believe these are really the bases on which financial institutions should value their trillion-dollar balance sheets. But we're stuck for now with mark-to-market accounting. At minimum, you should expect it to contribute extensively to continued volatility. Believe me, it already has.

<u>"Should" ≠ "Will"</u>

Lately I've enjoyed comparisons of recent developments to Frankenstein's loss of control over his monster, or to a man-made mutation that has escaped from the laboratory. Extensive financial sector experimentation took place involving unprecedented combinations of volatile elements such as leverage, securitization, tranching, derivatives and mark-to-market accounting. In the lab, experimental microbes would be quarantined until their dangers were fully understood. In the financial markets of this decade, on the other hand, they were rapidly popularized and peddled world-wide.

In 1998, Long-Term Capital Management became the poster child for the ability of sophisticated investment strategies to malfunction with grave consequences. This hedge fund invested in a highly diverse portfolio of fixed income arbitrage positions. These were situations where two related assets were trading in violation of their normal price relationship: one was a little more expensive relative to the other than history said it should be. LTCM bought into these small mispricings in large quantities, on enormous leverage, in the expectation that they would correct. The explanation for its subsequent meltdown was simple, according to the founder, John Meriwether: "The Fund added to its positions in anticipation of convergence, yet . . . the trades diverged dramatically."

For years these memos have quoted my good friend, Bruce Newberg, as saying, "Improbable things happen all the time, and things that are supposed to happen often fail to do so." Acting in excessive reliance on the fact that something "should happen" can kill you when it doesn't. That's why I always remind people about the 6-foot-tall man who drowned crossing the stream that was 5 feet deep on average. You have to be able to get through the low points. And the success of your investment actions shouldn't depend on normal outcomes prevailing; instead, you must allow for outliers.

Recent tales from the bust include a number of disasters that arose because things didn't work as they were supposed to:

- Although defaults **should** be independent, subprime-related securities collapsed when mortgage borrowers all over the country began to default at the same time.
- Auction rate notes should have delivered the benefits of both long-term financing (permanence) and short-term financing (low rates), because frequent rate resets **should have** eliminated the price risk that accompanies fixed-rate long-term debt holdings. But the reset process failed to work when the auctions attracted no bidders.
- At the top in commercial real estate during the second quarter of 2007, real estate investors were willing to buy New York office buildings at 3½% cash yields (with money borrowed at 5½%) because (a) rents **should** double to $150 sq. ft./year or, anyway, (b) someone else **should** be willing to pay more for it. So far . . . no.
- "Absolute return funds" **should** provide steady returns without vulnerability to market fluctuations. It turned out, however, that only completely hedged vehicles are completely without market correlation, and now a good absolute return fund may be one that goes down only half as much.
- A London hedge fund called Peloton gained 87% in 2007 and was named Credit Hedge Fund of the Year in January. Its long positions in AAA mortgage paper **should have** continued to hold up better than its subprime shorts. But the AAAs declined this year, and they'd bought enough on leverage to make the fund melt down in February.
- Credit default swaps **should** serve as a great way to transfer credit risk. But the market grew out of control – to $40-odd trillion of insurance coverage on $6 trillion

of debt – and no one knows just how it'll all work out. When CDS are traded around, the people who bought coverage have no way of knowing if their insurers' capital is adequate. Thus, efforts to off-load credit risk may have replaced it with "counterparty risk."

Clearly, investors only make investments because they expect them to work out, and their analysis will center on the likely scenarios. But they mustn't fixate on that which is supposed to happen to the exclusion of the other possibilities . . . and load up on risk and leverage to the point where negative outcomes will do them in.

At the same time, however, it's very hard to figure out how broad the range of considered possibilities should be. No investment action can withstand every possible development. Is there really such a thing as a "worst case assumption" short of a total loss? I often find myself asking one of the classic questions in investing: **How much effort and capital should we devote to preparing for the improbable disaster?**

Many of the recent problems occurred because investors expected outcomes other than the ones that arose. Had they been too optimistic? Or did the environment simply throw curves that no one should have been expected to handle?

<u>Leverage and Risk</u>

Two important investment principles should be embraced concerning leverage and risk:

First, leverage magnifies outcomes but doesn't add value. I've said that so often that I ought to stop. But just a few reminders:

- Leverage magnifies losses as well as gains. In Las Vegas, they say, "The more you bet, the more you win when you win." But they always forget to add ". . . and the more you lose when you lose." **Leverage is just a way to bet more**.

- Leverage magnifies outcomes but doesn't add value. It will make for higher highs and lower lows, and it might even produce an increase in the expected value . . . assuming outcomes are normal. But it can't make something a fundamentally better investment. **Thus, leverage absolutely cannot be equated to the contribution to return that comes from skill in selecting investments or in restructuring company operations or finances**.

- From time to time, people come up with structures that are purported to add to an investment's upside without adding proportionally to its downside. They rarely work. Or, expressed properly, **it makes no sense to expect them to enhance the expected return without increasing the range of outcomes and the risk of loss**. You may be able to take an investment with a 10% promised return and turn it into a vehicle that has a 90% chance of earning 13% and a 10% chance of losing everything. **But can**

you end up with something that has a higher expected return but isn't riskier? That's too good to be true.

- Finally, in addition to magnifying losses as well as gains, **leverage carries an extra risk on the downside that isn't offset by accompanying upside: the risk of ruin**. Leverage, when added to losses, can lead to margin calls and meltdowns. There is no corresponding benefit. This lesson is being well learned today.

Second, every investment or portfolio entails a variety of risks, and its overall risk is the sum of those.

Every investment embodies both the specific risk related to the individual company or asset and the systematic risk that is a function of its membership in a market – its beta. There also can be liquidity risk, legal risk, currency risk and political risk. Finally, risk is introduced by the structure in which an asset is held. Here I'm referring to the risk that comes with leverage.

To simplify for my current purpose, risk comes from the combination of what you buy and how you finance it. You can buy very risky assets, but if you don't lever up to do so, you'll never lose them to a margin call. Or you can buy fundamentally safe assets, but the combination of enough leverage and a sufficiently hostile environment can cause a meltdown. **In other words, investing in "safe" assets isn't necessarily safe, particularly if you've borrowed to buy them.**

We've seen this at work in recent days, as entities that invested in top-quality assets have run into trouble. For example, Carlyle Capital Corp. ("CCC") invested in AAA-rated debt of the two government-sponsored housing agencies, Freddie Mac and Fannie Mae. But it levered its equity 31 times to do so, buying $21.7 billion of securities on the basis of just $670 million of equity. That meant that if values declined 3%, its equity would be gone. Worried bankers pulled back their loans; CCC received margin calls it couldn't meet; the banks seized its assets; and the fund melted down.

Investment safety doesn't come from doing safe things, but from doing things safely. Put another way, anything can be screwed up by using so much leverage that its fluctuations can't be survived. That's why, in writing about LTCM in "Genius Isn't Enough" (January 1999), I said **leverage + volatility = dynamite**.

<u>Financial Self-Destruction</u>

The dramatic cyclical up leg of nearly five years (I'd say November 2002 through June 2007), as well as the far shorter but equally dramatic down leg that started last summer, have given me opportunity to reflect on a number of phenomena to be noted and lessons to be learned. You've seen the results in the last three memos ("No Different This Time," "Now What?" and "Whodunit"). I've reached a new view of how some things work, based on tying together several separate observations.

- **I've pointed out that one of the reasons models can fail to work is because markets are dynamic, not static**. Through frequent play, you can increase your mastery over a golf course, as you learn the consequences of each action and thus which are the right ones: if you hit the ball to spot A it'll roll toward the hole, whereas if you hit to spot B it'll roll toward the water. Eventual mastery is possible because the golf course doesn't change in response to your play. But fixing on tactics through which to master a market is unavailing, because the market is shaped by those who participate in it, and thus it responds and changes. No course of investment action – even if executed perfectly – can be right for all markets and all times. **In fact, when an approach becomes too well accepted, the widespread reliance on it becomes a source of danger.**

- I've devoted a lot of ink to Wall Street's innovation of financial products. Innovation becomes possible in up markets, when optimistic investors:

    - think about what might work and dismiss the likelihood of failure,
    - are willing to give something new the benefit of the doubt,
    - are impressed by early, easy successes, and
    - fear the consequences of failing to emulate competitors who enjoy those successes.

  In the last five years, these factors abetted unprecedented financial innovation, as quants assured prospective investors that the "fat-tail" events that could cause the new products to fail were most unlikely to occur.

- **But while the quants' predictions usually center on the high probability that events will fall within the normal range, the last nine months have given all of us the opportunity to witness events at the extreme.** This started last summer, when "once-in-a-lifetime events" became common. David Viniar, CFO of Goldman Sachs, may be remembered for saying in August that "we were seeing things that were 25-standard deviation moves, several days in a row." It's unusual for 100-year floods to become daily occurrences, but sometimes they do.

- **Finally, I've reminded readers about past bull market innovations that promised miracles but often failed when tested in bear markets.** One of the most easily recognized of these is "portfolio insurance." PI was a statistically derived technique that would enable equity exposure to be increased without a commensurate increase in risk. This was made possible by a process through which computer-generated sell orders would be implemented automatically in the event of a market decline, instantaneously scaling back portfolio risk. PI had its heyday in the period just before "Black Monday." But then, on October 19, 1987, the U.S. stock market declined 20%; beleaguered brokers didn't answer their phones; the sell orders weren't implemented; and PI ceased to be heard of.

A few months ago, the twentieth anniversary of Black Monday gave me the opportunity to reflect on the short life of portfolio insurance. **I began to think – and now I'm convinced – that PI didn't fail because Black Monday just happened to occur. Rather, it <u>contributed</u> to Black Monday's occurrence, and thus to its own demise.**

In my December memo "No Different This Time" I listed twelve lessons of 2007. Number four said that "widespread disregard for risk creates great risk." **In that way, in 1987 the widespread belief that equity exposure could be increased without similarly increasing risk led to an unjustified – and unsustainable – expansion of equity allocations. And the carefree buying this generated led to elevated stock prices from which a retreat was increasingly likely.** When the S&P 500 fell 10% on the Wednesday-Friday leading up to Black Monday and users of PI had the weekend to think things over, it seems they concluded that they had accepted too much risk; that they couldn't depend on PI to save them; and that they had to dump stocks en masse. **Thus, this innovation was not undone by a chance event. Its undoing was brought about by an event which it had, at least in part, caused.**

Innovation generally requires bullish assumptions, and thus it's easily accomplished in bullish times. Those optimistic assumptions add to the risk in the environment, and when eventually proved to be too rosy, they contribute to losses and to the products' failure. **The naked swimming which is encouraged by the rising tide certainly is exposed when the tide goes out. But I'd go further: in the dynamic environment of the marketplace, naked swimming eventually <u>can cause</u> the tide to go out.**

<u>A New Kind of Crisis</u>

People ask me whether things look familiar, and how this cycle compares to others I've experienced. I tell them this one's different in both degree and kind.

We've had collapses in the past, but never so broad-gauged and systemic. The earlier ones were the result of things going on in specific sectors or regions: LBO debt in 1990, real estate in 1992-94, emerging markets in 1997-98, and tech/telecom stocks in 2000-02. Most people would prefer to see the weakness centered in specific areas . . . and thus containable, treatable and avoidable.

This bust isn't sector-based, although it was ignited first in subprime mortgages. Instead, it stems from the broad application of the techniques I've been discussing: leverage, securitization, tranching and derivatives. Because Wall Street applied those techniques in so many ways, the current problems are generalized and pervasive and have the ability to cause losses in a wide variety of areas, irrespective of the underlying fundamentals.

The current bust arose against a backdrop of healthy fundamentals. The economy was growing. Commercial real estate wasn't overbuilt. Bond defaults were at record lows. Yet huge markdowns have taken place in these areas. Thus the solution will not come from addressing localized fundamental problems. Instead, the problem is hydra-headed, affecting a large number of areas due to contagion. Larry Summers put it this way:

> You have three vicious cycles going on simultaneously. A liquidity vicious cycle -- in which asset prices fall, people sell and therefore prices fall more; a Keynesian vicious cycle -- where people's incomes go down, so they spend less, so other people's income falls and they spend less; and a credit accelerator, where economic losses cause financial problems that cause more real economy problems.

There is no schematic diagram for the workings of the economy and the markets, as in "if we do A, the result will be B." That's particularly true for the current crisis, since some of the financial techniques that gave rise to it are new; others haven't been used to the same extent; and they've never been combined as they were in the last few years. **In particular, the workings of economies and markets depend heavily on psychology, which can't be treated as if it's hard-wired.** Thus the people trying to address this bust can only work from hypotheses and try possibilities.

The Fed and the administration are determined to solve the problem, but we're unlikely to have the unwind we need without pain. As I wrote in "Whodunit," in order for efficient capital allocation decisions to be made, an economic system that aims to create capital has to witness capital destruction from time to time. Efforts to avoid the pain would cause problems like unrecognized bad loans to linger, delaying a solution. **I'm no expert, but it makes sense to me that the quantum of pain on the way down has to at least approach the pleasure everyone felt during the boom.**

Other than just through the passage of time, the solution to the credit crunch – to the extent there is one – might be found in short-circuiting the deleveraging process described on pages 2 and 3. Thus, the authorities will try to get people to:

- face the music by recognizing and writing down problem assets,
- borrow money, even though the possible uses for it may seem ill-fated,
- make loans, despite the scarcity of capital and the risk of loss, and
- buy assets that are underpriced, even though prices seem only to go lower.

Interest rate cuts have made borrowing cheaper, and there will be more. Loans to banks will give them money they can turn around and lend. The government's decision to let Fannie Mae and Freddie Mac make bigger loans should make capital available in the starved housing market. If necessary, a government backstop of the agencies would do even more (but it also would introduce moral hazard). A holiday from capital requirements would allow regulated financial institutions to take writeoffs and clear their balance sheets without having to worry about falling below minimums. They might even try suspending mark-to-market accounting.

The Fed's recent announcement that it will swap Treasury securities for AAA-rated mortgage debt that isn't trading well is such an attempt to stem the deleveraging process. If things go as the Fed hopes, this exchange should:

- take some mortgage paper out of circulation, improving the supply/demand balance and relieving the downward pressure on prices,
- make it more palatable to hold and buy mortgage paper and, especially, for dealers to maintain inventories and make markets in it,
- reduce yields, and thus the cost of money in the economy, and
- give institutions collateral against which they can borrow (and then lend).

The collapse of Bear Stearns, on the other hand, illustrates a few important limitations. Brokers, like other financial institutions, are highly leveraged entities. The nature of their assets makes it impossible for them to repay their liabilities on demand. Thus, none can survive a "run on the bank" stemming from a loss of confidence. As I said in "The Race to the Bottom," they all offer the same product – basically, money – and if confidence declines, nobody will say, "Okay, there's a 5% chance I'll lose my capital, or access to it for a while, but it's worth it because their product is so superior." **Who'll stay despite a decline in confidence? No one. And what financial institution absolutely can't be the subject of a loss of confidence? I'll let you answer that.**

<u>Where Will It End?</u>

When I was a kid, there were a lot of cartoons showing men carrying sandwich boards (who remembers what they were?) that said, "The end of the world is at hand." So far, though, they've been wrong. Likewise, people said we had approached the end of the financial system around Black Monday in 1987, and when LTCM melted down in 1998. But we're still here. It seems we muddle through, despite all attempts to screw things up. It's my guess we always will.

It's tempting for worriers like me to consider apocalyptic possibilities. But it's not productive, so I've quit. I can come up with "China Syndrome" theories, but (a) I can't give them a high probability of coming to pass, and (b) there's little I can do. **The things one would do to gird for the demise of the financial system will turn out to be huge mistakes if the outcome is anything else . . . and chances are high that it will be.**

* * *

Fortunately, one of the most valuable lessons of my career came in the early 1970s, when I learned about the three stages of a bull market:

- the first, when a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone's sure things will get better forever.

Buying during the first stage can be highly profitable, while buying during the last will carry you over the cliff with the rest of the herd.

Relatively few people were eager to buy at the depressed prices of 2002-03. But buying grew in 2004-05 as prices rose and bargains became scarcer, and the pace became fevered in 2006 and the first half of 2007. This trend was captured in the soaring amounts investors committed to U.S. buyout funds:

2002-03	$ 52 billion
2004-05	200
2006-07	557

This growth in buyout capital was spurred on by high reported IRRs, which in turn were facilitated by dividend recaps and quick flips, themselves a symptom of the increasingly overheated capital market environment. **Had the high IRRs been the result of genuine investment skill or just well-timed risk taking?** So far we've learned a little about who swam naked – that is, for whom it was the latter rather than the former. We'll know for sure when the tide is fully out.

To aid in your consideration of the future, I've formulated the converse of the above, the three stages of a bear market:

- the first, when just a few prudent investors recognize that, despite the prevailing bullishness, things won't always be rosy,
- the second, when most investors recognize things are deteriorating, and
- the third, when everyone's convinced things can only get worse.

Certainly we're well into the second of these three stages. There's been lots of bad news and writeoffs. More and more people recognize the dangers inherent in things like innovation, leverage, derivatives, counterparty risk and mark-to-market accounting. And increasingly the problems seem insolvable.

One of these days, though, we'll reach the third stage, and the herd will give up on there being a solution. And unless the financial world really does end, we're likely to encounter the investment opportunities of a lifetime. **Major bottoms occur when everyone forgets that the tide also comes in. Those are the times we live for.**

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Aviary

Rather than dwell this time on a single subject, I want to cover a few. They may not seem related at first, but I believe they're birds of a feather.

<u>A Dead Duck</u>

While it's important that we have a sense for where we stand in terms of the market cycle, figuring that out can require some sophisticated inference. It's not often that we get crystal clear evidence of the pendulum's swing, or get it in short order. That's what makes the case I'll describe so distinctive.

"The Race to the Bottom" (February 2007) is one of my favorite memos. I think it presented clear evidence of the degree to which the pendulum of innovation and risk taking had swung to the undisciplined end of its arc. As I described, I was prompted to write it by an article in the Financial Times of November 1, 2006, which reported the following:

> Abbey, the UK's second-largest home loans provider, has raised the standard amount it will lend homebuyers to five times either their single or joint salaries, eclipsing the traditional borrowing levels of around three and a half times salary. It followed last week's decision by Bank of Ireland Mortgages and Bristol and West to increase standard salary multiples from four to 4.5 times.

After quoting that paragraph, I went on to draw what I thought was the compelling conclusion:

> **Any way you slice it, standards for mortgage loans have dropped in recent years, and risk has increased. Logic-based? Perhaps. Cycle-induced (and exacerbated)? I'd say so.** The FT quoted John Paul Crutchley, a banking analyst at Merrill Lynch, as saying "When Abbey are lending a multiple of five times salary, that could be perfectly sensible – or it could be tremendously risky." Certainly mortgage lending was made riskier. We'll see in a few years whether that was intelligent risk taking or excessive competitive ardor.

Auctions were taking place in the capital markets, and suppliers of capital were bidding against each other to make deals. In the case of UK home mortgages, the right to make loans would go to the institution willing to lend the highest multiple of annual salary . . . that is, willing to accept the most risk. In the last few years, there were many ways in which lenders and investors vied for deal flow on the basis of lowered return expectations and heightened risk. I considered Abbey's decision emblematic of this trend.

Thus, you can imagine my reaction upon reading the following in the Financial Times of April 8:

> First-time buyers with no cash savings were shut out of the housing market yesterday after Abbey became the last mainstream lender to stop offering 100 per cent mortgages. Borrowers who a month ago had a choice of mortgages offering 100 per cent of a property's value, will now need a deposit of at least 5 per cent . . . More than 20 lenders . . . offered 100 per cent mortgages at the start of last month. These have been pulled out of the market one by one as banks and building societies have distanced themselves from riskier lending.

Eighteen months ago, Abbey was the **first** to take lending standards to a new low in terms of times-salary-loaned. Now, it's the **last** to raise them with regard to down payments. Can there be a clearer example of the credit cycle at work?

For now, high-risk, no-worries lending seems to be a dead duck, a casualty of the corrections in risk aversion and demanded returns that have accompanied – or are at the root of – the current credit crunch. At the highs of the credit cycle, anyone can get money for any purpose. At the lows, even deserving borrowers are shut out. The former is highly expansionary, and the latter depresses economic activity. It'll always be so.

<u>The Canard of Free Market Infallibility</u>

"*Canard*" is the French word for "duck." In English, however, a "canard" is "a false or unfounded report or story." That English meaning comes from the French phrase "vendre des canards à moitié": to cheat, literally, to half-sell ducks.

A canard gained broad acceptance over the last decade or two, as faith in the ability of the free market to optimally allocate assets morphed into an irrational expectation that the free market would produce a continually rising tide, lifting all boats and bringing a better life for everyone. Here's my version of the saga.

One of the longest cycles I've witnessed has taken place in the area of government involvement in the financial industry. Prior to 1929 (I wasn't around for this part), there was little regulation. When much of the subsequent market collapse was attributed to improper conduct in investment banking and in investments generally, this led to significant new regulation.

For an interesting look at behavior in the 1920s, I'd recommend *Wall Street Under Oath*, written in 1939 by Ferdinand Pecora, who led the Senate investigation into the causes of the Great Crash and then became a New York State judge. It's a scathing indictment: imagine Wall Street operating in the 1920s unhampered by today's securities laws. Among other things, the Street's conduct led to the enactment of the Glass-Steagall Act of 1933 that mandated the divorce of commercial banks from investment banks, the Securities Act of 1933 and the Securities Exchange Act of 1934. Thus a strong regulatory regime prevailed – particularly under the

Democrats who controlled the White House for 28 of the 36 years from 1933 to 1969, and the Senate for 44 of the 48 years from 1933 to 1981. (In America, regulation is generally associated with Democrats and liberalism, and deregulation with Republicans and conservatism.)

The last 28 years have been very different, however, thanks primarily to Ronald Reagan and Margaret Thatcher, bolstered by centrist Clinton and Blair administrations, and helped along by Bush, Bush and Brown. For much of that time, the Fed was under the leadership of Alan Greenspan, who is philosophically indebted to Ayn Rand, a strong believer in free markets. **Free-market solutions were deemed certain to yield optimal economic decisions. Deregulation, privatization and market pricing went into full swing. Government involvement in policy making and control was disrespected. In short, it was assumed that the profit motive – Adam Smith's "invisible hand" – would maximize capital efficiency and, therefore, societal welfare.**

This trend reached its apogee in the last ten years. The Glass-Steagall Act was nullified; this allowed, for example, the combination of Citibank and Salomon Brothers. Other than lowering interest rates and providing liquidity to fend off weakness, the Fed employed a hands-off approach. Investment managers and investment bankers gained fame and huge fees for performance that showed which of them were the most talented. In every corner, the cry was "let the market decide."

Clearly, however, the events of recent years attest to excesses prompted by the profit motive. More was better: more leverage, more innovation, higher ratings for a given security and more activity in areas like residential real estate. **Equally clearly, not all of the free-market decisions were salutary; the proof can be found in the fact that *laissez-faire* has landed us in a financial crisis that some observers consider the potentially most serious since the Depression.**

How can we reconcile theory and practice: the way free-market decisions are supposed to work and the way they do work? The answer lies, I think, in the difference between short term and long, and in the coexistence of beneficial general trends and harmful exceptions. **Free markets allocate resources efficiently in the long run. But they can't make the tide rise continually, and while some boats rise, others will crash. Properly functioning free markets will give rise to times that set the stage for ruin, and then to times of ruin itself. They must create losers as well as winners, and capital destruction as well as capital creation.**

In pursuit of profit in a free market, people can engage in any behavior that's not illegal. (Well, actually, they can do illegal things too, but hopefully not for long.) Ethical considerations constrain some but not all, and ethicality seems to wax and wane. There's no doubt that profit pursuers sometimes push the envelope. Examples?

- The fees for appraising houses and rating securities went to those willing to assign the highest values. Did they let this affect their valuations?

- Thanks to disintermediation, financial institutions saw that they could earn fees for originating loans and selling them onward. Did the rewards for achieving volume displace the prudence they used to employ when putting their own capital at risk?

- Once financial engineers had built their new tranched products, they could sell them at lower yields (higher prices), sell more of them, and earn bigger fees if they could get them rated higher. For a given instrument, single-A was good, double-A was better and triple-A was best. The investment bankers marshaled the data and fed it into their models, tweaked to yield the best possible result. **I find it hard to believe they ever said, "Wait a minute; triple-A's too high given the underlying collateral" or "It can't be triple-A, because there are a few scenarios that, although unlikely, would yield terrible results."**

I'm not suggesting these people engaged in illegal activity or consciously did the wrong thing. They were just trying to make more money for their employers and themselves. But I believe their economic self-interest caused them to go to extremes in an environment that allowed candor, skepticism and ethics to be forgotten in pursuit of revenue maximization.

<u>A New Canard Takes Flight</u>

Government involvement in the private sector is like hemlines: it goes up and down. But it does so in very long cycles. It takes decades for it to reach maximums and minimums, and it can take a long time for the error of the extremes to be exposed.

In the last couple of months, we've read a great deal about the need for increased regulation, and there'll be more. There are several reasons for this:

- First, when there's a crisis, people tend to look for easy explanations. Insufficient regulation can be a good candidate.

- Members of the out-of-power political party can always make hay by blaming the governing party and its philosophy.

- **The truth is, whichever philosophy is in the ascendancy will deserve some responsibility for crises . . . because no approach is perfect. Regulation will always produce red tape and some inefficient, non-market solutions, and deregulation will always permit a degree of cowboy behavior.**

- It's easy to allege that the solution can be found in reversing the trend in regulation, and hard to disprove *a priori*.

So now the cry has been raised. People are jumping on the bandwagon, and those opposed are trying to head it off with promises of better behavior and self-regulation. As the Financial Times noted on April 10,

> Now credit and consumer confidence are ebbing, to the likely detriment of company profits. State intervention, which free marketers have argued against for centuries, has been royally legitimized.

Paul Volcker put it this way in the FT of April 12: "The bright new financial system – for all its talented participants, for all its rich rewards – has failed the test of the marketplace." Belief in free market omniscience has been laid to rest for a while.

The New York Times of April 15 described Bob Steel, Treasury Under Secretary for Domestic Finance, as being highly optimistic about a "superregulator" or "market stability regulator" that "would pass judgment on the capital levels, trading exposure and leverage of Wall Street's most sophisticated institutions." Yet within just the last two years, it says, "Mr. Steel has been co-chairman of one commission that claimed heavy-handed regulation was stanching financial innovation and another that argued that hedge funds could police themselves." Times certainly do change.

And in a sign of the times, *breakingviews.com*, an online interpreter of financial news, put it this way on May 14:

> The hands-off approach to financial markets now looks neglectful. . . . Greenspan's laissez-faire attitude to asset prices went along with paying little attention to bank supervision and positively welcoming the growth of less regulated financial institutions. Trusting financial markets to self-correct now looks wrongheaded. . . . **The authorities need to relearn that financial markets are too important and too impulsive to be left to operate unconstrained**. They work better with careful, consistent supervision. (Emphasis added)

In place of market-based decisions, we're likely to see more limits on free-market activity. I find it impossible to believe that the government will do a better job than the market of allocating assets and preventing excesses. But the current pain – when combined with regulation's avowed goals of avoiding harm, limiting predatory conduct and protecting the little guy – will make the trend hard to resist. As Martin Wolf wrote in the FT of April 16,

> More regulation is on its way. After frightening politicians and policy makers so badly, even the most optimistic banker must realize this. **The question is whether the additional regulation will do any good.** (Emphasis added)

Some specific actions have the potential to increase financial security, such as (a) increases in the capital reserves required against complex structured products and off-balance-sheet vehicles and (b) full and detailed disclosure of the latter. Some increase in regulation seems appropriate, especially with regard to off-balance-sheet entities, the source of most of the banks' losses. It's remarkable that just six years after Enron, where the worst abuses were hidden off balance sheet, another crisis was able to arise there. Banks benefit from deposit insurance (the government's seal of approval) and access to cheap Fed funds. Thus it's reasonable that, in exchange, **all of their entities** should be tightly regulated. This is especially true since it's been made clear that non-bank activities won't be permitted to sink our large banks.

But I think there are dozens of reasons why generally increased regulation won't work to the hoped-for extent. Here are my first twelve:

1. **It's far easier to find holes in regulations than to plug them.** Financial professionals innovate and expand. Regulators must try to catch up, often with outdated tools. By the time new rules are enacted, the financiers have moved on to invent new products and open new loopholes.

2. It's a simple fact that the regulated are more financially motivated to act than the regulators are to respond. It's not without effect that investment bankers work two or three times as many hours per week as the people who're counted on to police them.

3. The most skillful regulators often move eventually to work in regulated institutions, weakening the effectiveness of the regulatory process and spilling its secrets.

4. **Hedge funds and derivatives are behind many of the excesses, and it will be particularly hard to get them under control.** Today, one huge area of uncertainty is credit default swaps, particularly with regard to capital adequacy and counterparty risk. It's not a coincidence that CDS are derivatives with heavy hedge fund involvement. How might they be regulated?

5. **Derivatives are particularly hard to regulate because it's difficult to quantify the risk they entail.** Let's take the simplest example: you sell someone a "naked call" that gives him the right to buy from you for $2 apiece 100 shares of a stock you don't own. If the stock goes to $5, you lose $300 (the difference between the $2 you've been paid and the $5 you now must pay to buy 100 shares to deliver). If it goes to $10, you're down $800. At $100, you're down $9,800. At $1,000, you're down $99,800. At $10,000, it's $999,800, and so on. With naked call writing (and its equivalent, naked short selling), the potential loss is theoretically unlimited. So what's the right amount of risk to show on your balance sheet? No one can say. Should it be the "worst case"? And what is that? Or how about a model-derived estimate of the likely outcome? The last few months certainly showed those to be useless.

6. **It's worth noting that banks, probably the most regulated of our financial institutions, are reporting the biggest losses. Regulation can be improved and tightened, but it's hard to believe that it actually can be counted on to prevent crises.** Similarly, the weaknesses in the mortgage loan generation process were huge, but no regulator spoke out against them.

7. It's been proposed that financial institutions should be required to stress-test their ability to cope in difficult times. But how bad an environment should they be able to survive? What is the worst case, and should banks have to prepare for it? **If banks always were required to be able to survive the conditions of February and March, for instance, they might never make a loan.**

8. **Regulatory proposals are also likely to include calls for more and better risk management**. But the risk management profession's exertions in the last ten years probably exceeded the sum of its efforts prior thereto. Those efforts certainly didn't head off the current crisis. In fact, it's highly likely that risk managers' blessings led to a false sense of security in recent years, and thus to more confident (and greater) risk taking.

9. Since many of the biggest recent errors occurred in the area of credit ratings, **it's appropriate to ask whether regulation could make ratings more accurate.** According to an article in the Herald Tribune of April 25,

   > Senator Chris Dodd . . . practically begged Christopher Cox, the SEC chairman, to ask for new authority. He suggested that perhaps it would be a good idea to leave credit ratings to some kind of non-profit agency that would not have conflicts of interest. Both he and [Senator] Shelby suggested that the SEC should revoke the operating license of a credit rating agency that was wrong too often.

   Can you imagine anything along these lines working? **Would you like to see credit ratings being set by an agency lacking economic motivation?** Who would determine whether they'd been "wrong too often"? And would "wrong too often" include ratings that proved to be too low, or just too high? I've seen a lot of both in the last forty years.

10. Likewise, some of this cycle's greatest gaffes came from having people make loans who lacked an ongoing stake in their creditworthiness. So it's been suggested that lenders should be required to have money at risk in loans even after they've been securitized and sold onward. Could regulators possibly prevent a highly motivated lender from getting around this requirement? How, for instance, would they keep an institution from hedging its bets through offsetting positions in derivatives?

11. A number of the proposals I've read relate to financial executives' compensation. Bankers' bonuses should be related to performance that has been adjusted for the risks entailed. And they should be long-term in nature and subject to being clawed back if profits turn into losses later on. **Can government possibly regulate compensation in the private sector? And should it under our system?** I would say "no" to both.

12. **Finally, the main things that gave rise to the pain this time around were imprudence, insufficient skepticism and excessive faith in innovation**. The International Herald Tribune of March 29 said, "Democrats in Congress . . . are pushing for tougher restrictions on risky lending." And I read elsewhere a suggestion that mortgage lenders should have to act responsibly. How can these things be regulated? **How might a regulator require good judgment, and how would it be measured?**

I think Alan Greenspan did an excellent job of summing up the situation in an op-ed piece in the Financial Times of April 7,

> Regulators, to be effective, have to be forward-looking to anticipate the next financial malfunction. This has not proved feasible. Regulators confronting real-

> time uncertainty have rarely, if ever, been able to achieve the level of future clarity required to act pre-emptively. Most regulatory activity focuses on activities that precipitated previous crises.
>
> Aside from far greater efforts to ferret out fraud (a long-time concern of mine), would a material tightening of regulation improve financial performance? I doubt it. **The problem is not the lack of regulation but unrealistic expectations about what regulators are able to prevent.** How can we otherwise explain how the UK's Financial Services Authority, whose effectiveness is held in such high regard, fumbled Northern Rock? Or in the US, our best examiners have repeatedly failed over the years. These are not aberrations.
>
> The core of the subprime problem lies with the misjudgments of the investment community. . . . Even with full authority to intervene, it is not credible that regulators would have been able to prevent the subprime debacle. (Emphasis added)

Martin Wolf sized the challenge in the FT of April 16:

> If regulation is to be effective, it must cover all relevant institutions and the entire balance sheet, in all significant countries; it must focus on capital, liquidity and transparency; and, not least, it must make finance less pro-cyclical.

That's a tall order. The results are unlikely to stack up well against the goals.

No, government intervention doesn't hold the key to a financial system existence free of extremes and crises . . . any more than *laissez-faire* does. But the trend is likely to be in the direction of regulation. The truth is that cycles, with their dangerous excesses, will cease to occur only when human emotion and the pursuit of profit no longer go to extremes. Neither government intervention nor the free market will ever produce that result.

<u>The Black Swan</u>

The best-known bird around today is *The Black Swan*, the second book from Nassim Nicolas Taleb. You may remember Taleb as the author of *Fooled by Randomness*, which I've described as an essential read (see "Returns and How They Get That Way," October 2002, and "Pigweed," December 2006). He's an ex-hedge fund manager and self-styled philosopher whose books are nearly impenetrable (I suspect intentionally). But they also contain some incredibly important ideas.

The main thrust of *Fooled by Randomness* was that while many of the forces that shape investment performance – or history in general – are random in nature, people often ignore that fact and give them meaning that would be warranted only if they weren't random. Thus the top performing investor in a given year may be the manager – in Taleb's terminology, the "lucky idiot" – who took an extreme and unwise position and was bailed out by a highly improbable event that occurred by chance. For that reason, one year of outstanding performance says absolutely nothing about the likelihood of another.

The Black Swan continues in that vein, emphasizing the dangers of overestimating knowledge and predictive power. The book gets its name – and its theme – from some unusual Australian birds which, never having been seen before foreigners began to visit, were considered in Europe not to exist.

According to Taleb, there are three criteria for a "black swan." The first two are that it should be "an outlier" and carry "an extreme impact." **The fact that these "highly consequential events" are infrequently occurring and improbable often is taken to mean they're nonexistent and impossible. The difference between the two may be small, but it's highly significant.**

Taleb's third criterion is that black swan phenomena have "retrospective (though not prospective) predictability." **And because people are able to "concoct explanations" for them after the fact, they end up believing themselves capable of understanding the causes and predicting future occurrences**. In short, they underestimate the limits on foreknowledge with regard to these events – a regular theme of mine, as you know – and underrate the role of randomness. To simplify their world and render it subject to established statistical analysis, quants attribute standard properties – like the familiar bell-shaped curve – to events that are far less regular than they should be for this approach to be valid.

The publication of *The Black Swan* last year was extremely well timed, because many of the infamous recent events satisfy Taleb's criteria.

- The greatest errors in mortgage securitization arose because "home prices have never declined nationally" was taken to mean "home prices can't decline nationally."
- Innovative financial products were modeled on the basis of common probability distributions that may have been inapplicable to the phenomena being studied. Thus the possibilities were oversimplified by recent business school graduates who'd never been out bird-watching in the real world.
- In the end, events that had been described as highly unlikely happened. But they shouldn't have come as complete surprises and should have been anticipated. Models had led people to consider things with a 1% chance of loss as riskless. **Once in a while, however, people need a reminder that "unlikely" isn't synonymous with "impossible."** Black swans do occur.

Now, with the final bullet point above in mind, let's talk about the black swan as a practical matter, not a topic for philosophic rumination. It's easy to say black swans should be prepared for, and that the people who fell into the last few years' traps ignored obvious risks. My December memo "No Different This Time" included the following among the key lessons of '07:

> **Investment survival has to be achieved in the short run, not on average over the long run.** That's why we must never forget the six-foot-tall man who

> drowned crossing the stream that was five feet deep on average. **Investors have to make it through the low points.**

This statement makes obvious sense. Certainly investors must brace for untoward developments. There are lots of forms of financial activity that reasonably can be expected to work on average, but they might give you one bad day on which you melt down because of a precarious structure or excess leverage.

But is it really that simple? It's easy to say you should prepare for bad days. But how bad? What's the worst case, and must you be equipped to meet it every day?

Like everything else in investing, this isn't a matter of black and white. **The amount of risk you'll bear is a function of the extent to which you choose to pursue return. The amount of safety you build into your portfolio should be based on how much potential return you're willing to forgo.** There's no right answer, just trade-offs. That's why I went on from the above as follows:

> **Because ensuring the ability to [survive] under adverse circumstances is incompatible with maximizing returns in the good times, investors must choose between the two.**

One of the most interesting questions I've pondered over the years is this: **How much should we spend – be it in the form of insurance premiums or forgone returns – to protect against the "improbable disaster" (my term for the black swan)?** But that's all it remains: a question. It's for each of us to answer in our own way.

<u>Birds on a Wire</u>

There's an old riddle about ten birds sitting on a telephone wire. A hunter shoots one. How many are left? The usual response is nine. But the correct answer is none; the rest are frightened by the gunshot and fly away. Maybe it's a joke, but it illustrates the ease with which ramifications – what my British friends call "knock-on effects" – are overlooked.

In "It's All Good . . . Really?" I discussed the way people were describing the events of last summer as an isolated subprime crisis and ignoring the potential for contagion. Now most see that the "subprime crisis" was just the first act in what might be a long period of generalized economic difficulty and market weakness.

The longer I think about economic and investment trends, the more I view every development as a reaction to something else. And you've probably noticed my inability to talk about current events without discussing their precursors. I see the events since last summer – and those that will stretch into the coming months and perhaps years – as a chain reaction:

- The **subprime crisis** resulted from trends that had been building during the preceding years: leverage, securitization and tranching, financial engineering, looser ratings, unregulated non-bank lending, weaker loan standards and rising risk tolerance. The risk embodied in these things came home to roost in residential mortgages first because it's there that they were applied to the greatest extent and to the weakest underlying collateral. Too many triple-A securities were created from each pool of non-investment grade mortgages, and they collapsed as soon as default rates surpassed the models' assumptions.

- The **credit crunch** was an obvious next step. A number of more generalized developments resulted from the mess in residential mortgages:

    - rising risk aversion,
    - higher demanded risk premiums, and thus lower prices for risky assets,
    - the withdrawal of leverage and liquidity,
    - leveraged fund meltdowns and frightening headlines,
    - losses at banks and thus endangerment of their capital adequacy, and
    - hoarding of capital and the unavailability of new loans.

- This resulted in **problems at financial institutions**. Losses on highly leveraged investments were sure to lead to a crisis mentality, which could morph easily into a plain old crisis. What are the characteristics of financial institutions?

    - **high leverage**,
    - **near-total reliance on short-term deposits and borrowings** to fund illiquid, longer-term assets,
    - **risk bearing** – that's what their business consists of, and it's by doing so that they earn lending spreads (if they borrowed safe and lent safe, where would the spread come from?), and
    - **extremely low transparency**.

  What greater recipe could there be for a drying up of confidence? If a financial institution loses the confidence of its customers, what's to prevent a run on the bank? Nothing, as the UK found out in September with Northern Rock and the US found out in March with Bear Stearns. And what can inject fear into an economy more than doubt about the safety of its financial institutions?

- The main shoe left to drop concerns **the impact on the broader economy**. Economies run on confidence. People spend on non-necessities because they expect the future to be good and their incomes to grow. Businesses expand plant, workforce and inventory because they expect sales to increase. Financial institutions lend because they expect to be repaid with interest. Investors provide capital because they expect the value of assets to increase. When doubt is shed on these expectations, the growth process stalls. When the economy contracts for two consecutive quarters, a recession is declared, and positive assumptions become further in doubt.

Already, businesses are reporting declining or disappointing earnings (even General Electric). Unemployment is on the rise. Higher prices for oil and food are likely to cut into consumers' ability to spend. And their psyches have been damaged by scary headlines they may or may not understand. Consumer confidence is at low levels, and fewer Americans expect an improving future. Much of the growth in consumer spending has been abetted by the more widespread availability of credit. Now, less credit should mean less spending. These aren't the conditions for a vibrant economy.

There's a strong consensus that we'll see a recession – and a possibility we're in one already. GDP grew in the first quarter, but final sales were down and output increased only because businesses added to inventories. These additions likely were involuntary, and when stopped or reversed, GDP growth certainly could go negative.

Please note that a depressed economy isn't the end of the line. Slower consumer and industrial activity could feed back to the beginning of the process, causing further house price depreciation, further write-downs, a further credit contraction and so forth. And then, when levels get low enough, something mysteriously will cause the cycle to turn positive.

Things don't happen in isolation in economies and markets. Birds do flock together. The implications of past events will spread further.

Phoenix from the Ashes?

As always, there's a tug-of-war going on between the optimists and the pessimists. This time, however, the stakes are unusually high and the rhetoric proportional to the potentially momentous consequences.

Over the last few weeks, the markets rose based on statements to the effect that the worst had passed: "We're closer to the end than the beginning" (Lloyd Blankfein of Goldman Sachs). "Maybe 75 to 80 percent over. . . " (Jamie Dimon of JPMorgan Chase). The worst is "behind us" (Richard Fuld of Lehman Brothers). The subprime market in the U.S. has reached its eighth inning or maybe the "top of the ninth" (Morgan Stanley's John Mack).

On the other hand, John Thain of Merrill Lynch said, "I hope those who say we are at the end are correct. I am somewhat more skeptical." Dan Fuss of Loomis Sayles, a highly experienced bond manager with an excellent track record, said, "This is the most worrisome financial situation I've seen in my working lifetime" [which approximates fifty years]. And George Soros described this go-round as "much more serious than any other financial crisis since the end of World War II."

People are talking about March 17, the day JPMorgan Chase rescued Bear Stearns, as the bottom. Psychology was terrible in the weeks leading up to that event; things would have melted down much further in the absence of a rescue; and psychology and markets picked up substantially thereafter. **Certainly that day was "a bottom," but I'm not so sure it was "the bottom."**

The Bear Stearns rescue dealt with the credit crunch, investor attitudes and the possibility of a downward spiral among financial institutions. But it didn't mark the end of mortgage

defaults or economic weakness. Mortgages will continue to go unpaid, and the numbers may accelerate if interest rates take adjustable-rate loan payments higher and if house prices continue to fall. Further, nothing that was done in March will preclude economic slowdown, falling corporate profits or defaults on debt. Finally, it doesn't seem to have done much for the availability of credit. Several elements are likely to remain – or become – further depressants:

- **Bank write-downs will continue to be reported.** The majority of the banks' subprime-related losses may have surfaced **as relate to the current level of house price depreciation and mortgage default.** That doesn't mean these trends won't go further, and thus that the reservoir of unreported losses won't be refilled. The IMF has projected total mortgage-related losses of $1 trillion. Certainly the write-downs announced to date haven't approached that figure. And there's a broad consensus that most holders haven't been as forthcoming on this subject as the U.S. banks.

  Progress is being made toward breaking the logjam, but we're not done yet, and there continue to be additions to the backlog. As banks report large write-downs, I can't help but sense that the immediate reaction is, "I wonder how much more remains." Only when people stop thinking that way will real progress have been made toward easing the credit crunch.

- Similarly, sales of "hung" bridge loans are increasing, and clearly some investment banks are willing to take their medicine with regard to the extent to which loans bought in 2006 and 2007 are unsalable at par. Recently we have seen sales at 90, often with financing provided by the sellers. **But just as in the case of mortgage losses, it's quite possible that new obligations to lend will re-burden the financial institutions' balance sheets**, as companies draw against the excess credit lines that were arranged at the time they changed hands in buyouts.

- **The availability of credit is still a question mark**, although things seem to be getting better. Despite the Fed's low rates and all central banks' massive injections of liquidity, inter-bank interest rates still incorporate significant yield spreads and volumes are limited. On April 28, the Financial Times quoted John Maynard Keynes:

  > Whilst the weakening of credit is sufficient to bring about a collapse, its strengthening, though a necessary condition of recovery, is not a sufficient condition.

  In other words, the FT said, "just because the banks are not going bust does not mean that they can lend as before – nor would they if they could."

- Commercial real estate prices, like home prices, are coming off irrational highs achieved because of the oversupply of investment capital in the last few years. **The coincidence of a broad real estate collapse with a significant recession has the potential to make this a painful episode.** But few prominent commercial defaults and failed refinancings have been reported to date.

- **The economic news, while not dire at the moment, isn't rosy**. Consumer spending, inflation, employment and business investment all remain exposed to negative future developments. Default rates among highly levered companies have just begun to rise.

- **Finally, the viability of derivatives such as credit default swaps has yet to be tested**. That means either (a) they're not going to cause trouble, or (b) they're going to cause trouble and have yet to do so. This is another case where potential negatives have yet to be dispelled.

The markets have seen substantial gains since the time of Bear Stearns's rescue. They give me the impression that people who refrained from trying to "catch a falling knife" may have concluded that they waited too long, and thus they rushed to buy out of fear that they'd look bad if they stayed uninvested. The FT of April 28 summed up in a way I thought was very much on target:

> The awkward truth is that nobody knows for sure how severe an impact the credit crunch will prove to have on the global economy and on financial markets.
>
> On fundamental grounds a wealth-preserving investor might well feel justified in being cautious until the extent of the downside becomes clearer. **The beauty contest approach** [in which, rather than bet on who's the prettiest contestant, people bet on who most people will judge to be the prettiest contestant]**, however, suggests that many professional investors are taking the view that however bad their private fears, the majority of their counterparts are looking through the immediate fallout to a rosier future.**
>
> Just as markets anticipate eight of the next five recessions, so too they can look forward to eight of the next five bull market recoveries. (Emphasis added)

I'm not saying the pessimists are right and the optimists are wrong, or that we truly face an ongoing crisis. Rather, I think the possibility is there and several more shoes remain capable of dropping. Importantly, while mortgage securities and leveraged loans have gone through the wringer and arguably might be cheap, most other assets are as yet unscathed or have rebounded. Stocks, in particular, do not seem to reflect the possibility that this economy's goose is cooked, having declined only slightly from 2007's all-time highs.

* * *

So you want to know, "Is it over?" Here's my bottom line:

- **There's been a significant correction of the excesses of a year ago.** Prices are down and risk premiums are up. Fear and risk aversion have been brought back into the equation; unbridled optimism is no longer the norm.

- **A good part of the losses have been recognized that relate to the fundamental deterioration – and especially the mortgage defaults – to date.**

- **Psychology, which reached "end-of-the-world" levels in the days leading up to the rescue of Bear Stearns, is back from the brink and on the upswing.** Although this could be a worrisome sign of inadequate caution, the risk that psychology will spur a massive downward spiral seems to be off the table for now.

- **However, the foreseeable future is not without significant risks, many of which are real, not psychological** (to the extent the two can be distinguished in economics). There could easily be further house price depreciation, causing more mortgage defaults and requiring additional write-downs. American consumers, buffeted by rising prices for energy and food and concerned about the future, could easily slow their spending and further weaken the economy. And we continue to believe that many high-priced, highly leveraged private equity deals will fail to survive an economic slowdown.

The outlook continues to call for prudence . . . although not as much or as urgently as a year or two ago. Then, people were investing at low returns in the belief that nothing could go wrong. Today, that optimism has been dispelled and prospective returns embody more generous risk premiums.

However, only when a great deal of caution has been built into the markets – and hopefully an excess of caution – is it time to turn highly aggressive. We're not there yet, but there's reason to believe we're moving in that direction.

May 16, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: Doesn't Make Sense

Academics have their theories about market efficiency. Because market participants are well-informed and rational, they say, markets make correct decisions and smoothly assign the right price to each asset. It's for this reason that investors can't routinely find the mispricings they need in order to be able to beat the market.

But investors – and most of the people living on this planet, for that matter – are far from the unemotional computing machines the academics assume them to be. They make faulty decisions, fall for scams and swing from one irrational position to another all the time. **In fact, I marvel at how many things take place in the worlds of business, investments and politics that stem from irrationality and just don't make sense**. It's my purpose here to write about a few.

Letting the Market Call the Tune

In "Whodunit," I talked about Chuck Prince, the ex-CEO of Citigroup. Early in July of 2007, he astutely observed, "When the music stops, in terms of liquidity, things will get complicated." However, he went on to add, **"as long as the music is playing, you've got to get up and dance. We're still dancing."** Because Citigroup danced as much as the other banks or more – and lost as much or more on subprime-related write-downs – Prince lost his job in November 2007.

The portion of Prince's statement that I've highlighted seems emblematic of the attitudes that prevailed from early 2003 until the summer of 2007. People were doing risky things – often even though they recognized the attendant risk, as Prince seemed to do – because they saw no alternative if they wanted to remain competitive.

Upon hearing of Prince's departure, my immediate reaction was to think (a) when a firm fares so badly, the CEO may deserve to lose his job, and (b) to avoid that fate, Prince just had to cause Citi to avoid the risky behavior he identified. If he had done the latter, Citi would be among the big winners today instead of the losers; it wouldn't have to recapitalize by selling equity at depressed prices; and instead it would have funds with which to take advantage of today's better market environment. So in saying that if the music was playing, Citi had to dance – and thus letting the market call the tune – Prince's leadership was flawed.

Compulsory Short-Termism

But is it right to say Prince and Citi could have avoided trouble by refusing to go along? Let's do what some DVDs let you do nowadays: go back and consider an alternative ending. It's July 2005 instead of July 2007. Presciently, Chuck Prince says, "When the music stops, in terms of liquidity, things will get complicated. We're not going to get caught in that trap. As of today, we're adopting a conservative stance toward loans, mortgages, subprime, CDOs and SIVs. The others can dance all they want; we're sitting this one out."

What would've happened? Rather than lose his job in late 2007, he probably would have lost it sooner. Why? Because from whenever he made that statement until July 2007, Prince would have looked dumb. While other banks were gaining market share, Citi's share would have been shrinking. And while other banks were borrowing on the cheap to make mortgage-related investments at seemingly attractive spreads, Citi would have been on the sidelines, forgoing easy profits. Shareholders would have been yelling for Prince's scalp.

The bottom line is one of my three favorite adages: **Being too far ahead of your time is indistinguishable from being wrong.**

Of the two things I think are most wrong about American business, the worst is short-termism. (The other is the ability of executives to thrive while their companies do poorly.) **Companies are rewarded for short-term success and penalized for short-term failure, whereas few people ask about the long term**. The only thing that matters is "What have you done for me lately?" A lot of this emanates from stockholders.

In a memo several years ago, I listed a few phrases that have sunk into obscurity over the course of my career. They included "fiduciary duty," "preservation of capital" and "dividend yield." Another is "long-term investor."

Most investment managers are measured against a benchmark every quarter and expected to add value. Some clients have their fingers on the trigger, ready to axe a manager who underperforms for a year or two. For this reason, managers sit with their own fingers on the trigger, ready to dump a stock or bond whose short-term performance lags. And company CEOs whose securities are laggards are likewise on the hot-seat, with boards that rarely support executives who disappoint Wall Street.

Too many people think of the long run as nothing but a series of short runs. The way to have the best five-year investment record, they think, is by sequentially assembling the twenty portfolios that will produce the best performance in each of the next twenty quarters. No one wants to invest in a company that may lag until long-term investments pay off down the road. They'll just sell its stock today, assuming they'll be able to buy it back later.

Understanding this, companies face great pressure to emphasize short-term results. What might they do in response?

- Maximize revenues (perhaps by stuffing pipelines and offering discounts that accelerate future sales into the present).
- Minimize expenses in slow-to-bloom areas like research and development.
- Borrow to buy back stock, because debt capital is cheap and equity is expensive (despite the fact that equity provides safety and leverage amplifies risk).

Do you want your companies doing these things? Probably not. But do the collective external pressures force companies in these directions? Absolutely. **The things that maximize profits in the short run often serve to decrease profits and increase risk in the long run, but they can be mandatory these days.**

Investors are increasingly short-sighted, and none more so than some hedge funds, with their emphasis on year-by-year incentive fees. The average stock might deliver a return roughly in line with the growth in corporate profits, and the stocks of better companies should outperform in the long run, but hedge funds (and their investors) expect more. They're strongly motivated to hold a subset of stocks that will be the best near-term performers. One approach is to take positions and then pressure companies to "maximize shareholder value." With their focus on short-run performance and short-run compensation, many of the things they advocate – like spin-offs, stock buy-backs and oversized dividends – can be less than optimal for the long run. But that's not their concern.

This kind of behavior exemplifies the debate over *laissez-faire* described in "The Aviary" in May. **In the long run, it should be good for society to have capital in the hands of sophisticated, focused, bright managers who are free of guidelines and can go anywhere in pursuit of profit. In theory, it should be a positive that they're willing to bet against the herd, adopt unpopular positions and take on unresponsive managements. But in the short run, they can have a destabilizing effect, especially when several act in common**. Maybe it just proves that free-market solutions – like just about everything else – have both positive and negative aspects.

If Chuck Prince had taken Citigroup to the sidelines in 2005, it's highly likely that some hedge funds would have tried to force him out. And with Citi looking unduly conservative, the board might not have been in a position to resist. **So being right isn't always enough when you run a public company. You have to be right in the short run. And in choosing a course of action, the one that's right for the short run generally will be preferred over the one that's right for the long run. None of this seems ideal.**

Unreliable Ratings

Probably the group that had the most power and yet covered itself with the least distinction over the last few years – and has been outed to the greatest extent – are the credit rating agencies. The rating agencies were accorded quasi-official status as the policemen of the credit markets, and they failed miserably.

This is nothing new. I've always considered the rating agencies to be error-prone, and much of my career has consisted of taking advantage of their mistakes. They've often rated seemingly safe bonds too high and risky bonds too low. They've been slow to adjust ratings, but when finally they did change, they usually overshot. **The bottom line is that managing a bond portfolio according to ratings would be somewhere between unavailing and disastrous. Profits are more likely to be found in gaming against the ratings.**

Nevertheless, when the government felt Wall Street had to be policed and debt investors protected, they turned to the agencies. Before doing so, I doubt anyone checked to see how accurate ratings have been. Now we know. Thousands of ratings of structured mortgage securities turned out to be too high and were adjusted downward, often many notches at a time. The CDO tranche that didn't have to be downgraded is the exception, not the rule. In other words, the ratings were grossly wrong.

In my view, a triple-A rating shouldn't just imply a low probability of default, but a low probability of downgrading as well. The agencies may say they were blindsided by developments in residential defaults, but I think a triple-A rating should also imply a low probability of being blindsided. To follow on with the "black swan" thought process, something potentially subject to an "improbable disaster" shouldn't receive a triple-A rating. But clearly a lot did.

A Model Destined to Fail

The bottom line's simple: you can't get dependable results from a faulty process. Most people realize now that the rating process was highly flawed.

I've written before about the biggest weakness: the fact that rating agencies are hired and paid by the issuers whose debt they're rating. In "Now It's All Bad?" (September 2007), I compared this to a trial where the defendant picks and pays the judge. But I realize now that I overlooked an important element in the equation. **It's actually a trial where the defendant gets to ask a number of prospective judges what verdict they'd reach before choosing one**. Issuers can describe a proposed issue to multiple agencies, hear back as to what rating they're likely to assign, and then hire the one they want.

Think about an agency's incentives under this arrangement: the fee goes to the one willing to supply the highest rating. Go along and your profits grow; stand on principle and you're left behind.

When I came into this business in the 1960s, Moody's and Standard & Poor's made their money selling subscriptions to their publications. Thus their customers were investors, and they weren't beholden to the issuers. But when they began to derive most of their revenue from the issuers, the agencies understood who was buttering their bread.

There's a further problem: only above-average judgment can make you a superior investor. The consensus view of the future is incorporated in market prices. Only someone more astute than the consensus can help you do better than average.

Now let's turn to the rating process. **Anyone can compute current financial ratios and see how a company's doing today. And the future looks the same to the average person as it does to the consensus. Thus, for a helpful assessment of a company's prospects, you need someone who can foresee possibilities and risks better than most.** But if someone possesses above-average insight into bonds' prospects, will he assign credit ratings for a living, or will he get a job managing investments? Money isn't everything, but most people tend toward their highest and best use. **I think it's fair to say the rating agencies don't attract bond gurus.**

Since the ratings business is highly competitive and profit margins are slim, agency analysts tend to be paid for high ratings and "responsiveness," as opposed to unique insight. Principled, conservative decisions aren't rewarded, as is now plain to see.

Moody's disclosed in May that, because of a programming error, eleven European CPDOs (complex investment vehicles formed to write large amounts of credit insurance) had been incorrectly rated triple-A instead of double-A. Okay, everyone makes mistakes. But the plot thickens.

According to *The New York Times* of July 2, the law firm of Sullivan & Cromwell conducted an investigation for Moody's and found that the ratings hadn't been corrected even after the error came to light. Its report,

> . . . blamed employees in charge of monitoring and adjusting ratings for considering "factors inappropriate to the rating process" after the errors were discovered. . . . In a statement, Moody's said unidentified employees had violated a code that required analysts to consider only credit factors, not "the potential impact on Moody's, or an issuer, an investor or other market participant."

It's not exactly clear what happened, and I don't think anyone's trying to make it particularly clear. It seems, however, that Moody's employees overlooked the ratings errors that came to light for "business reasons."

According to an article on ratings in *The Wall Street Journal* of May 23, Moody's and Fitch,

> . . . acknowledged they have switched analysts assigned to rate bonds after receiving requests to do so from bond issuers or their bankers. Changes usually were made after a specific bond was rated, meaning the analyst wouldn't work on the bond issuer's next deal, according to current and former officials at the credit-rating firms. . . .
>
> At Moody's, at least one analyst in the group that rated collateralized debt obligations, or CDOs, was moved off a particular investment bank's deals within the past few years after bankers requested an analyst who raised fewer questions, according to people familiar with the matter.
>
> Another mortgage analyst at Moody's was moved to the firm's surveillance unit after a Moody's official agreed with an investment banker's opinion that the analyst was too fussy, a person familiar with the situation said. . . .
>
> "**We're a service business**," says John Bonfiglio, group managing director of structured finance at Fitch. [Emphasis added]

Lastly, on July 9, *The New York Times* provided these tidbits from internal rating agency emails, which were part of an SEC report on its investigation of the agencies:

> "We do not have the resources to support what we are doing now."
>
> "I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision and if so, how much?"
>
> "We are meeting with your group this week to discuss adjusting criteria for rating C.D.O.'s of real estate assets this week because of the ongoing threat of losing deals."

It doesn't make sense for unregulated and sometimes unprofessional organizations, operating under the wrong incentives and performing tasks that are above their heads, to be appointed watchdogs of the capital markets. But that's what happened.

When It's Good to Be Bad

Only in an Alice-in-Wonderland world can there be benefits in having a weak credit rating. But today's complex, rules-based accounting system makes it possible.

On May 18, *The Wall Street Journal* published the story of Radian Group, a bond and mortgage insurer. Although its business was poor, an accounting gain enabled it to report a $195 million net profit for the first quarter, as opposed to the $215 million loss it would have reported otherwise. However, this was an unusual gain. It didn't arise because the value of Radian's assets went up, but rather because the value of its liabilities went down.

Here's how, according to the *Journal*:

> One of the basic rules of accounting says that a reduction in the value of a liability leads to a gain that usually boosts profit. Under the new [mark-to-market accounting] rule, companies have to take into account the market's view of their own financial health when considering the market value of some liabilities. In this case, a company's poor health can lead to a reduction in the liability's value. . . .

In other words, if you owe money and the probability you'll pay your debts declines, your financials strengthen. But shouldn't a declining ability to pay be associated with weakness, not strength? **Before enacting rules like this one, someone should ask if they make sense. It doesn't seem anyone did**.

Similarly, mark-to-market accounting can – in the extreme – require a company to value its assets at the prices that would be realized if they all had to be sold today. And those prices are likely to decline as more assets are assumed to need dumping. Liquidation values are far different from intrinsic values or going-concern values. Do we really want to value assets on the assumption that they're all going to be sold immediately? What purpose does that serve?

<u>Blame the Speculators</u>

The current debate over the role of speculators in oil pricing reminds me of Rep. Noah Sweat's classic answer when asked in 1952 what he thought about whiskey:

> If you mean whiskey, the devil's brew, the poison scourge, the bloody monster that defiles innocence, dethrones reason, destroys the home, creates misery and poverty, yea, literally takes the bread from the mouths of little children; if you mean that evil drink that topples Christian men and women from the pinnacles of righteous and gracious living into the bottomless pits of degradation, shame, despair, helplessness, and hopelessness, then, my friend, I am opposed to it with every fiber of my being.
>
> However, if by whiskey you mean the oil of conversation, the philosophic wine, the elixir of life, the ale that is consumed when good fellows get together, that puts a song in their hearts and the warm glow of contentment in their eyes; if you mean Christmas cheer, the stimulating sip that puts a little spring in the step of an elderly gentleman on a frosty morning; if you mean that drink that enables man to magnify his joy, and to forget life's great tragedies and heartbreaks and sorrow; if you mean that drink the sale of which pours into our treasuries untold millions of dollars each year, that provides tender care for our little crippled children, our blind, our deaf,

> our dumb, our pitifully aged and infirm, to build the finest highways, hospitals, universities, and community colleges in this nation, then my friend, I am absolutely, unequivocally in favor of it.
>
> This is my position, and as always, I refuse to be compromised on matters of principle.

I guess you could say Rep. Sweat found the merits of whiskey to be in the eye of the beholder. So, it seems, is the role of "speculators" in the escalation of oil prices.

Politicians don't seem eager to tell constituents the truth about oil:

- We use too much of it (perhaps because it's cheaper in the U.S. than elsewhere).
- Our cars are less efficient than they should be.
- A good bit of this year's increase in the dollar price of oil may be attributable to the fact that a dollar now buys considerably less goods (or other currencies) than it did in December.
- Oh yeah: and Washington completely dropped the ball in areas like fuel efficiency standards.

So it shouldn't come as a surprise that some politicians are blaming the price rise on other people: speculators. But what is a speculator? That'll bring an answer like Rep. Sweat's. Ask a lay person, and the answer will be a shiftless gambler who takes unwise chances in pursuit of unjustified profits.

In the commodities market, a distinction is made between "commercial" and "non-commercial" traders. A commercial trader may buy oil, for example, in the course of its main business (like an airline, utility or oil refiner) and thus have a reason to hedge against price rises. Or it may be an oil producer that wants to protect against falling prices by selling its future production at the current price. People making value judgments deem these to be "legitimate" reasons.

Speculators, on the other hand, are non-commercial traders – anyone without direct reliance on oil in its business. The current furor implies they don't have valid reasons for buying oil.

But what about the long-term investor who wants to own natural resources as part of a balanced portfolio? Or the individual seeking protection against inflation? Or the sovereign nation that wants to put part of its reserves into something other than depreciation-prone dollars? These motives aren't "illegitimate," and they don't deserve to be disparaged.

In particular, some have suggested that pension funds should be barred from trading in oil. This has to have more to do with scapegoating and short-term perception than it does with preventing improper behavior or solving our nation's energy problem.

Prices – for everything – are set by the interaction of supply and demand, and short-term swings in these things can swamp long-term fundamentals. Certainly, incremental demand from the kinds of buyers described above may have lifted the recent price of oil above what it otherwise would have been. But upward pressure doubtless came as well from (1) increased consumption (especially in developing countries like China and India), (2) rising international tensions, and (3) the simple fact that, **because a dollar now buys less than it used to, it's logical for sellers to demand more of them per barrel**. How much of the blame rightly falls on the speculators?

Thirty billion barrels of oil are consumed each year worldwide, worth over $4 trillion at today's prices. Can the buying of oil by investors – even speculators – really be responsible for much of this year's $1 trillion increase in the total cost of those thirty billion barrels? I don't think that explanation makes much sense.

When major problems arise in the economy or markets, politicians and the media often find it attractive to point fingers at alleged evil doers. That's a lot easier than admitting that regulation fell short, or that we face intractable problems. We're sure to see criticism and even prosecutions following the current economic episode. But any misdeeds are likely to be symptomatic of a lax environment, not causes of the problem, and punishing them is unlikely to be an effective part of the solution.

<u>Eliminating the Fear of Loss</u>

A couple of weeks ago, I had a great talk with Tom Petruno, an insightful business reporter for the *Los Angeles Times*. Calling on our shared experience as Californians, he presented what I consider a very apt analogy. It went like this:

We've all heard about the connection between the Fed's actions and moral hazard. There've been many incidents and scares over the last couple of decades: Black Monday, the meltdown of Long-Term Capital Management, Y2K, the bursting of the tech bubble, 9/11, and a recession here and there. Each time, the Fed rushed in with interest rate cuts and increases in liquidity designed to prevent or offset their depressing effects. A few times, it was said, these actions averted a collapse of the world financial system.

But the cost was moral hazard: a growing expectation that the Fed would bail out imprudent risk takers. By behaving in ways that cause people to think they'll always come to the rescue, authorities encourage risky behavior. And we all share the cost of rescuing the risk takers, whether we participated or not. In this way, the risk taking encouraged by the Fed's policy of protecting participants caused the risks to grow ever-higher. The result is a housing bubble and full-scale credit crunch that together have cost millions of people money and perhaps their homes, pushed financial institutions to the brink, and caused the government to expend a lot of its problem-solving resources.

Tom asked if I didn't see a parallel between the management of our financial system and the policy toward forest fires. The western states experience forest fires all the time, for any number or reasons: lightning, stray cigarettes, campfires that get out of control, even arson. While undesirable, these frequent fires have a good side: they get rid of the relatively small amount of dry brush created each year during our dry season.

But in recent years, the authorities promptly extinguished these fires to make sure they wouldn't get out of control. As a result, brush was permitted to accumulate from year to year. And this May, when a series of freak lightning storms started 2,000 fires, the built-up brush turned some of them into major conflagrations at a time when fire-fighting resources were stretched thin.

This past Sunday, the 27th, the *Los Angeles Times* kicked off a major series on forest fires. Here's part of what it said:

> The government's long campaign to tame wildfires has, perversely, made the problem worse. . . . By stamping out most wildland blazes as quickly as possible, the Forest Service has stymied nature's housekeeping – the frequent, well-behaved fires that once cleaned up the pine forests of the Sierra Nevada and the Southwest. Now, woodlands are tangled with thick growth and dead branches. When fires break out, they often explode.

Sound familiar? Clearly, the analogy between financial crises and forest fires is solid. And I told Tom that just as the Fed's growing tendency to solve every problem led people to take greater risks, the policy of fighting fires early also created moral hazard by encouraging people to build homes further into the forest. It fell to the community to keep those unwisely built structures safe, just as the government now feels it has to rescue subprime borrowers and financial institutions.

Capitalism can produce great results, but participants have to be allowed to both win and lose. If they aren't, they come to believe the only possible outcomes are winning or, at worst, breaking even. **Good business decisions can be made only if the hope for gain is balanced by the fear of loss. The latter must not be eliminated. The system must be allowed to work. Of course, this has to be balanced against the desire to prevent catastrophes, necessitating some very difficult choices.**

<u>Counting on a "V"</u>

Finally, I want to provide a word of caution regarding expectations for recovery. I hear predictions that things will come back next year. Earlier this month, for instance, an elevator news display cited a forecast that home prices will rise 4% in 2009, almost offsetting 2008's decline.

People have become conditioned to expect V-shaped declines and recoveries. We saw quick downs and ups in the markets or the economy in 1987, 1990, 1994, 1998 and 2002. But it doesn't have to be that way. Those of us who were in this business in the 1970s know different.

The '70s saw a 37% decline in the S&P 500 in 1973-74; huge losses in the "nifty-fifty" growth stocks; the Arab oil embargo in 1973; inflation in the high teens; short-term interest rates in the 20s; and an infamous *Business Week* cover story, "The Death of Equities." Stagflation ruled, and there seemed to be no way out of the wage-price spiral. People wore buttons promoting President Ford's WIN program ("Whip Inflation Now"), but neither the buttons nor the program did any good. New York stockbrokers were driving cabs, and it was extremely difficult to find employment in the investment industry. That means that in order to be part of the investment industry in the '70s, you pretty much had to have your job by 1969. And that in turn means you had to be at least 21 by 1969 . . . and sixty or older today. There aren't many of us still working.

I can tell you, no one was talking about a "V" in the 1970s. We experienced financial malaise lasting almost a decade. The best we felt we could hope for was a "saucer-shaped" recovery, a far different story.

As I said in "The Tide Goes Out" in March, economies aren't hard-wired, and no one knows in advance how things will go. Further, some of the ingredients this time never have been seen before. When taken together, I see problems that may not go away any time soon and the possibility of a sluggish period lasting more than months or quarters.

First, let's consider financial institutions and the housing market. In recent years, as everyone knows, the former combined with the latter to create a bubble based on the combination of leverage, innovative structuring and heedless buying. Institutions and housing have been gravely hurt, and they're likely to bring harm to additional sectors of the economy. For their downward spiral to be arrested, I see four things that have to happen:

- Home prices have to stop going down.
- Home mortgages have to be made available.
- Financial institutions have to stop experiencing incremental write-offs.
- Financial institutions have to be able to raise additional capital with which to rebuild their balance sheets.

The problem I see is that each of these four things is dependent on the occurrence of another – a classic chicken-or-the-egg problem. Write-offs won't stop until home prices stop going down. Prices won't stop going down until mortgages become available. Mortgages won't become available until lenders can raise capital. And capital won't be freely available until write-offs stop coming. Which will happen first, facilitating the others? What will cause it to happen? When?

These things will happen, of course. Maybe for reasons we can't foresee. Maybe for no apparent reason. And maybe just because things got so bad they couldn't get any worse. I go through this only to show why I don't see an easy or quick solution. But then I'm rarely an unbridled optimist.

Second, consumer spending is a principal lynchpin of the economy, and there's no reason to think the near-term outlook here is positive:

- Employment, earnings, the wealth effect and consumer psychology in general are all likely to be negative, and thus to act as depressants on the economy.
- Higher energy costs and higher mortgage payments (driven up as inflation worries lift interest rates) both have the potential to hamper consumer spending.
- Consumers aren't likely to be able to borrow as easily as in the past. Credit cards may not be available as freely. Borrowing on home equity could be nearly impossible and, anyway, there isn't as much equity to borrow against.
- The American consumer hasn't saved in years and thus has very little in the bank to spend.
- The consumer may realize that savings are essential – at last. If so, in order to save, he'll have to spend less than he makes – at last. This, too, will depress spending.

The record over the last decade – and even the first half of 2008 – shows the American consumer to be incredibly resilient and unwilling to break the spending habit. **Thus it isn't impossible that spending will stay strong . . . just illogical.**

Basically, I think this economy has to hunker down. Financial institutions have to strengthen their balance sheets. Consumers should do so as well. There should be less risk tolerance and financial innovation. Regulation is destined to increase, and in exchange for its support of financial institutions, the Federal government is likely to demand that they carry less leverage and take less risk. Thus financing could be scarce.

But positives do exist. Dollar-denominated exports look very cheap to the rest of the world and will bolster the U.S. economy. And the Fed will do everything possible to help (but it can reduce rates only so far and has to remain vigilant regarding inflation).

The usual tug-of-war is taking place between the optimists and the pessimists. On July 18, the *Financial Times* quoted Deutsche Bank chief executive, Josef Ackermann, as saying, "We are seeing the beginning of the end of the crisis." But the very next day, *The New York Times* quoted Alan Blinder (ex-vice chairman of the Fed board of governors): "The financial system looks substantially worse now than it did a month ago."

On balance, I continue to think the odds favor economic sluggishness for a not-insubstantial period of time. **Given today's general dearth of beaten-down assets outside of residential real estate and financial institutions, investing gradually probably won't cause you to miss great opportunities. But it will keep you out of trouble and ensure that you have capital with which to take advantage of any bargains ahead. In my book, going slow here makes the most sense.**

July 31, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: What Worries Me

Especially in times like these, people often ask what keeps me up at night. Well I'll tell you a few things it's not: that Oaktree will suddenly depart from its investment philosophy; that some of our accounts will trail their benchmark for a year; or that the markets will be so weak that we can't earn returns (or so strong that there aren't any bargains). And it's certainly not that I'll meet up with that bus I hear so much about.

My real worries concern the big picture and the long term. Most of them have to do with America's future and the world in which my children and grandchildren will live. In this regard, I think there's a lot to worry about. I'm not going to spend this memo discussing things as mundane as investment cycles, or as cosmic as environmental deterioration, global warming or terrorism. There's enough to talk about in terms of largely economic issues without going into areas like those. And having covered them below, I promise to go back to my day job thinking about investments.

I hope this memo will be well received. I fear some may think it's un-American or unpatriotic, but I assure you I'm neither. It'll certainly seem negative and dreary; I admit up front that I see the problems more clearly than the solutions. But I hope this memo will raise some questions in readers' minds and contribute to constructive debate.

Further, I hope it'll be of interest to Oaktree's clients outside the U.S. While you may not be exposed to these issues to the degree we are at home, (a) you may want to know what I think the U.S. is up against, and (b) at bottom, we're all in this together – all nations are intertwined. And who knows: you might be looking for farsighted help with your countries' long-term problems, just like I am.

<u>The American Century</u>

The truth is that it's great to live in America. Ours isn't the only wonderful country, or the only good place to live, but we've benefited from:

- 230 years of stable democratic government;
- 140 years without civil war;
- the generally peaceful co-existence of a highly heterogeneous population;
- very high levels of personal freedom and opportunity;
- a highly functioning free-market economy;
- great educational institutions;
- vast land mass and natural resources; and
- a highly productive, inventive and entrepreneurial citizenry.

No one alive today has experienced anything other than American preeminence. In fact, the twentieth century has been called "The American Century." But there's no reason why the twenty-first century necessarily will be another.

National preeminence – like most other things – is cyclical, not permanent. Given time, leading nations overextend themselves, lose their energy or squander their advantages. They get fat and happy, and they relax. Underdogs try harder and rise from a lower base. Perhaps they study the leaders and learn how to emulate them. And perhaps they begin to make better use of untapped resources and underutilized labor forces. They may even benefit as the leaders share the wealth (such as the U.S. did through the Marshall Plan after World War II). Regardless of the reasons, just as the U.S. supplanted colonial powers like England, France, Spain and Portugal that had held sway earlier, countries like China, India, Russia and Brazil now seem likely to grow faster than the U.S. in the twenty-first century, narrow the gap and enjoy their time in the sun.

In Praise of the Melting Pot

One of the greatest sources of America's growth and preeminence has been the bounty of immigration. With the exception of the Native American Indians, there was no one here 500 years ago. We're a country of immigrants. We've benefited as waves of foreigners moved to the U.S. to escape mistreatment or seek opportunity. I never forget that my grandparents weren't born here, and how far I've been able to progress nonetheless.

When I was a kid in the 1950s, a joke asked why we were ahead of the Russians in technology. The answer: our German scientists were better than theirs. **This country attracted people from all over the world, gave them unprecedented opportunity, and permitted the most talented to rise to the top. What a great recipe for success.**

But today the outlook isn't the same:

- The stick isn't as strong as it used to be: economies and living conditions in other countries have gotten better and continue to do so.
- The carrot isn't as strong, either: we're no longer the only country offering opportunity.
- The barriers to entry threaten to rise, as some Americans consider immigration one of our biggest problems. And 9/11 has made visas, including those for students, much harder to obtain.

My involvement as a university trustee has exposed me to a developing trend. It used to be that foreign students were eager to come to the U.S. to gain a higher education and then stay to pursue their fortunes. They still want to come for the education, but today many want to return to participate in economic booms in their native countries. This makes me wonder whether there'll come a day when the opportunity for a first-class U.S. education isn't as much of a draw, because other countries will have developed comparable educational institutions of their own. That day seems far off – institutions like these don't arise in an instant – but it isn't an impossibility.

Many newcomers to the U.S. have found success in engineering, where their technical skills could be put to good use and language skills may have been less critical. Now, however, we hear from Silicon Valley that engineers are harder to attract and retain because of the trends described above. I'm told that in certain fields (like aerospace), U.S. engineers are declining in number and their average age is rising.

America's preeminence depends in part on continuing to attract the world's best and brightest, but the outlook for doing so is not all it was in the past.

Standard of Living

In many ways, including materially, Americans have enjoyed a wonderful standard of living over the last hundred years. Considering creature comforts such as housing, food, sanitation, healthcare, leisure and luxuries, ours may have been the highest standard of living in the world. That raises three questions:

1. Why should we continue to enjoy the highest standard of living?
2. Why should it continue to improve?
3. And why should the rate of improvement outpace that of the rest of the world?

We often see poll results showing that increasing numbers of Americans doubt their children will live better than they do. We'd like them to, but why should they? Other than technological improvements which doubtless will continue to make life better for everyone, why should our standard of living improve monotonically? And improve relative to the rest of the world? Certainly the advantage in this regard can shift to other countries, just as it shifted to us in the past.

The World's Highest Earners

One of the reasons for our high standard of living is the fact that Americans have been paid more for doing a given job than everyone else. This was fine as long as (a) the U.S. enjoyed the benefits listed on page one, and (b) significant barriers protected the status quo. But why should this go on? How can it go on?

Think about two cities. City A has more jobs than people, and city B has more people than jobs. Initially, people in city A – where labor is relatively scarce – will be paid more for doing a given job than people in city B. **The key to their continuing to earn more is the existence of barriers that prevent people from moving to city A.** Otherwise, people will move from city B to city A until the ratio of people to jobs is the same in both cities and so are the wages. **Among other things, geographic inequalities are dependent on the immobility of resources.**

For much of the last century, barriers kept our pay high. Other countries' output wasn't as good as ours. Some lacked investment capital, and some were decimated by war from time to time. Perhaps they didn't possess our ability to generate technological advancements or our managerial skills. High transportation costs, tariffs, prejudices (when I was a kid, "Japanese transistor radio" was synonymous with "low quality") or legal restrictions (e.g., keeping foreign airlines from competing freely in our markets) may have protected American wages. International trade wasn't what it is today. But all of these things can change over time, and it's hard to see how the earnings supremacy of U.S. workers will be sustainable.

Among other things, our legacy airlines became weighted down with high-cost labor contracts and all have gone through bankruptcy to shed them. Likewise, high healthcare costs added to the cost of every car built in the U.S. to an extent that hurt our competitiveness. Thus the U.S. auto industry lost domestic market share, sent production overseas, and consists of three companies of uncertain creditworthiness.

Protectionism favors the erection of trade barriers, but it's usually resisted based on the totality of its effects. **In international trade, just as in local markets, the only real way to maintain and grow market share – and thus to protect earnings power – is to offer the best combination of price and value. Regulations and tariffs won't make us competitive in the long run, and without offering a superior bargain, the supremacy of our standard of living will not be preserved in a world of lower barriers.**

What Do You Make?

We're all familiar with the pattern: as communications improve and barriers and transportation costs come down, jobs move from the U.S. to China, India or some other low-cost country, spurred by producers' desire to increase profits or just remain competitive. There's even a word for it: outsourcing. As a result, with each passing year, the U.S. manufactures less of its needs and the world's.

I looked at myself on the way to work this morning. Everything I had on was made outside the U.S.: suit, shirt, tie, shoes, eyeglasses, even underwear. My car, TV and stereo are imports. So's my computer. I bought some of these things from American companies, but they were made elsewhere. (I don't think I'm unpatriotic in buying these things: I'm just pursuing high-quality goods at the best ratio of value to price.)

There's no way around it: we don't make much anymore. What does that mean? I have to admit I don't know. I'm not enough of an economist to have the answer. But I wonder a lot about how an economy can function if it doesn't make much.

Joe does Ed's legal work, and Ed keeps Joe's books. Sarah cuts Bob's hair, and Bob cooks in the restaurant where Sarah eats. Rich drives the bus that takes Sue to the bank, and Sue handles Rich's loan application. And, of course, someone like me manages investments for all of them. But how does an economy function if nobody actually makes anything – and if we have to buy all of our stuff from other countries? I'm exaggerating for impact, but you get my meaning. We make less and less each year – and we consume more.

Can an economy be successful if it consists of nothing but service providers, government workers and retailers? (Think about the unions you hear the most about in connection with the upcoming presidential election: the Service Employees International and the American Federation of State, County and Municipal Employees – no longer the Teamsters and Auto Workers.) Can a nation prosper without producing goods? I just don't know the answer.

And then there's the question of where we'll get our stuff from. Of course, we'll buy it from other countries. **But that leads to other questions: To what extent will rising inflation in cheap-labor countries raise the cost of the imports on which we depend so thoroughly? What will we sell to the rest of the world in order to get currency with which to buy their stuff? And for how long will they buy it from us?**

Certainly American goods have become less price-competitive, and other countries have learned to produce for themselves. Think about what we export. Movies? Computer software? Other countries are increasingly making their own. Financial products? Now there's an area where we're still exporting. But given the results with subprime and CDOs, might we have damaged that franchise? (Here's a piece of trivia for you: what's our biggest export by volume? This trick question hinges on the inclusion of the words "by volume," and the answer is waste paper for recycling. Certainly this doesn't indicate a manufacturing advantage on our part, or value we're adding to the global economy.)

Increasingly, we're reduced to designing products, styles, software and media content for production elsewhere. What's the long-term outlook in that regard? How long will others need us in that role? It's been said we're becoming a nation of burger flippers. An exaggeration, certainly, but how much of one? And what are the ramifications? One last thing (and don't tell my friends I said this): **What does it mean when investment bankers and money managers – who add relatively little to economic output – are among a society's highest paid members?**

<u>Earning and Spending</u>

When I meet with people in other countries, here's how I describe the typical American (again, exaggerating for effect): $1,000 in the bank and $10,000 owed on the credit card; makes $20,000 a year after taxes and spends $22,000. That may not be strictly accurate, and I haven't checked my facts. But I think it presents the general picture.

Many people have little if anything saved up – we often read about people being bankrupted by a bout of sick leave – and the savings rate has fallen to roughly zero.

People probably think of their pension plans, IRAs and home ownership as eliminating the need for savings. But certainly recent events have shown the holes in that approach.

U.S. consumers increase their debt continually, seemingly without ever thinking about paying off the balance or of how they might accomplish that (short of winning the lottery). It doesn't seem to trouble people when they spend more than they earn, whether through the use of credit cards or by taking out loans, including borrowing and spending the equity in their homes. In all of these regards, the American consumer doesn't seem to give any thought to how this movie will end (I last raised this in "Hindsight First, Please" in October 2005). **It's just a matter of people wanting to consume more than their income supports. Saying "I want it, but I can't afford it" seems hopelessly old-fashioned in the America of today.**

<u>Who Else?</u>

I wish only consumers acted this way. Go back three paragraphs, though, and ask whether my description of the typical American doesn't also relate equally to our government: constant deficit spending and continually increasing debt.

Our fiscal deficit and national debt aren't enormous relative to other developed nations and to our GDP. And I don't make a value judgment that it's wrong to run deficits from time to time. The traditional view of fiscal policy is that deficit spending should be used counter-cyclically, expanding it in weak times to stimulate the economy, and contracting it (perhaps paying down debt) to throw on some cold water when the economy becomes heated. **But I wonder whether constant deficits, and a national debt that always grows faster than GDP, can be right in the long run**.

Right now, the U.S. Treasury has to borrow to cover our fiscal deficit. As the debt grows, the interest bill rises – and in connection with the rescue of Fannie Mae and Freddie Mac, Congress just approved an increase in the national debt ceiling from $9.8 trillion to $10.6 trillion. Pretty soon, we may have to borrow just to pay the interest.

Might we ever pay off our debt? How? More importantly, what are its ramifications? Dependence on foreign lenders puts us in quite a box:

- To attract foreign capital, it's better to pay high interest rates. But the need to keep them high could complicate the job of stimulating our economy when it slows.
- The fact that our negative balance of payments pumps excess dollars into circulation abroad can put downward pressure on the value of the dollar.
- Weakness in the dollar can make foreigners reluctant to hold reserves in dollars, and to buy Treasury debt that will be repaid later in dollars that buy fewer goods. What happens when we pump out so many dollars – and they depreciate so much – that foreigners refuse to accept our promises of payment? How then will we fund our deficits?

This debate has gone on for years. Our politicians want to borrow so they can continue to spend more than comes in via taxes. But shouldn't we ask what amount of debt is right to leave for future generations? As the federal deficit grows relative to GDP, so will the national debt, and future generations will be saddled with an increased interest burden (even if there's never a need to repay).

Again, I'm not enough of an economist to know the answers. (And even economists disagree about the significance of national deficits and debt.) **But I wonder whether it's prudent for a country to spend more than it makes in both good times and bad**.

Affording Retirement

In college macroeconomics, I learned that Social Security was one of the important components of the "safety net" preventing a recurrence of the Depression. With help from their personal savings and the private pension system, Americans would be able to afford retirement, rather than end up on the streets in their old age.

Now I worry about the outlook for my fellow Americans in this regard. Many have little saved, as I mentioned above. According to Tom Friedman, writing in *The New York Times* on June 29, "[Since 2000,] our national savings have gone from 6 percent of gross domestic product to 1 percent . . ."

The defined benefit pension system is shrinking, especially with regard to new enrollments. Defined contribution plans and IRAs replace it somewhat, but their voluntary nature leaves big holes in the safety net. (I admire the wisdom of mandatory pension plan participation in countries like Australia, Denmark and the Netherlands; people can find it hard to save rather than spend, so it's a good idea to give them "encouragement" in that regard.)

Finally, the impending shortages in the Social Security System have been very well documented, and the best the optimists can say is "it won't be a problem anytime soon." Add in more years spent in retirement by people living longer and a declining ratio of workers paying into Social Security to retirees drawing out, and the outlook is very problematic.

Will large numbers of Americans be unable to afford retirement? Will they experience deprivation? Will they become a burden on the community and the nation? I see no easy or pleasant answers to these questions.

The Healthcare Dilemma

Healthcare is another example of a problem crying out for a solution, but the stumbling blocks are many.

- Healthcare is expensive, and the cost rises all the time, in part because costly new medicines and procedures are developed.
- Americans are living far longer, so there are more years in which sickness is high and costs are elevated. In the modern era, few people (understandably) are content to slip into decline and death without a fight.
- Remarkably in our advanced society, nutrition and health awareness seem to be going in the wrong direction, along with the level of exercise for large portions of the population. Obesity has become an epidemic, bringing with it serious health problems.
- Patients want the best care, and doctors want to provide it. How can society respond to this demand when many patients can't afford the care, or even a reasonable co-payment? I once read a *Wall Street Journal* op-ed piece on healthcare with a title something like, "If You're Paying, I'll Have Steak." That's the inevitable outcome when third parties foot much of the bill.
- It's hard to effect triage: who'll tell an 80- or 90-year-old that he shouldn't get a joint replacement or costly drug therapy? If a hospital or the insurance company wants to say "no," all hell breaks loose.
- The economics of medical care have become somewhat anti-social. Doctors face declining pay and status, and systems designed to control healthcare costs stick healthcare professionals with very distasteful administrative burdens.
- Amazingly for such a rich nation, statistics rank American healthcare low in the developed world. (I'd guess, however, that this is the result of averaging a lot of people enjoying very good treatment with the less fortunate who fare much worse than their counterparts in countries with broader government-sponsored programs.)
- One answer is some form of socialized or universal healthcare, but by nature such a system is likely to be costly, bureaucratic and/or ineffective. Other countries have national health systems, but it's hard to get appointments, and I imagine everyone gets care that's okay but not great.
- If there's a collective scheme, can the healthiest and wealthiest be forced to participate? If not, how will it function if they opt out of it, pulling away healthcare resources for "concierge" medical service and draining low-burden members from the pool of insureds?

Taken together, these points suggest possible compromises but no ideal answer. **The bottom line is that we can't afford to give the best possible medical care to every citizen. No country can, and anyone who says we can is probably running for office.** We can either (a) give moderate care to everyone or (b) retain a system under which the results are all over the map and the less fortunate get very little. Neither of those is perfect, but I think they're the choices.

<u>Growing Inequality</u>

The capitalist system produces gains because of a Darwinian process in which participants are spurred on by economic incentives and the most successful enjoy great rewards. The system runs on the ability of those who are more talented and/or work harder to do better than others. Inevitably the better life also goes to some who are undeserving and just lucky or born into wealth; that's undesirable but inescapable. But it's not good if the margin by which some do better than others is too big.

I think it was in the '70s that I came across a great explanation for America's economic success:

> When the English factory worker sees the boss drive out in his Rolls Royce, he says, "I'd like to put a bomb under that car." But when the American worker sees the boss drive out in his Cadillac, he says, "I'm going to own a car like that some day."

That's one of those little stories containing a great deal of truth. **Economic motivation and a feeling of opportunity are great positive forces, while class resentment is equally negative. We want America to remain a meritocracy where all citizens believe in their ability to get ahead.** Too much of a disparity could eat into the belief in our system.

Pay at the top has exploded relative to all else. At Citibank in the mid-1980s if my memory's correct, CEO Walter Wriston, the world's top banker, made about $250,000 a year. Twenty-five years later, the CEO of a money-center bank or large corporation makes 50 to 100 times that . . . and 400 times in a year when options pay off big. What other segment of our workforce has done as well? We're in a period of general income stagnation, when lots of Americans haven't made strides like the executive class . . . or any strides at all.

I don't expect executives to indulge in self-restraint, since people rarely do things against their own short-term interests. But I'd like to see boards take the position that huge incomes should come only with great benefits for the companies' owners. And that a single great year might not merit enormous compensation that year. Entrepreneurial rewards can be appropriate for successful executives, but they should come only for long-term success and should be at risk in the event of failure.

I believe thoroughly in the free market system, and that the worst thing imaginable would be government regulation of salaries or incomes. But I also worry about the consequences when the benefits to the fortunate few are perceived by everyone else to be unfairly disproportionate and unrelated to achievement.

In the past, in addition to the fact that incomes weren't so enormous at the top, the income gap was narrowed by the fact that people could do pretty well at the bottom. Millions of menial and blue-collar jobs were created as our economy expanded. Even without much education, people could enjoy the good things in life, including cars, TVs and vacations, along with good public school educations for their kids and the possibility that most of those kids would have better jobs than their parents. Which of those elements is equally true today?

In the "Information Age," the lack of a college degree or computer literacy is a much greater handicap than it used to be. With non-information jobs increasingly moving overseas, what jobs will our less-educated citizens occupy? You might say education holds the answer, but (a) our public education system is in decline, and (b) how, especially given these jobs' greater productivity, can there be enough tech-based jobs to keep our entire population gainfully employed?

The Energy Problem

When I began to drive in 1964, oil was $4 a barrel and gasoline was 29 cents a gallon. Then, in 1973, OPEC put an embargo on oil exports. We saw lines around the block at gas stations, and we were permitted to fill up just every other day. The price of oil jumped to $35 by 1980 or so, and then it subsided. It spent the period from 1986 to 2001 between $10 and $30 before going on to hit $92 in 2007 and $148 earlier this year.

The bottom line, however, is that from about 1880 until a few years ago, we were in an environment of cheap energy. **For over a hundred years, the price of oil didn't rise, meaning it got dramatically cheaper in inflation-adjusted terms. This encouraged exactly the behavior one would expect: rapidly growing oil consumption, lagging increases in supply, little attention to the development of alternative energy sources, insufficient investment in mass transit, and weak efforts at conservation.**

We're guilty of profligate energy consumption. Americans use SUVs or pickups capable of carrying eight people or huge payloads to do their grocery shopping. And they feel free to live 50 to 75 miles from work and to drive there alone in their behemoths. We just haven't had incentives to use energy thoughtfully.

Maybe you have your favorite example of energy waste; mine is supermarkets' removal of doors from their freezer displays. Can you imagine what future archaeologists will say about the decision to cool a whole store just to make it easier to buy some frozen food?

It's not a coincidence that with oil much more expensive, Europe uses far less energy per unit of GDP than we do. Because of high taxes, gasoline traditionally has cost 2 to 4 times as much in Europe as it has in the U.S. Today it's about $9 per gallon, and yet I don't hear Europeans complain much. That's because they drive smaller, more fuel-efficient cars, live closer to their jobs, and make major use of mass transit. They even ride bicycles to work.

The most important element in responding to the energy problem is expensive oil. Low prices have encouraged high demand and discouraged additions to supply. The opposite will be the case only if prices are high. Politicians' attempts to play to the crowd by artificially reducing the price of oil – through releases from the government's Strategic Petroleum Reserve, banning "speculation" or providing a holiday from gas taxes, as was suggested in the spring by would-be presidential candidates from both parties – will do nothing but add to demand and depress supply.

In the future, pre-industrial societies will become industrialized, and millions of newcomers to the middle class worldwide will want cars. **We need an energy policy that is constructive for the long run, encouraging us to use less oil and find more.** Everyone's squawking about gas prices and looking for culprits. **But as long as gasoline costs much less than Snapple or Evian water, resources will be misallocated and we won't see real progress.**

We also would benefit from regulations that mandate fuel efficiency, encourage alternatives and penalize high oil use (or at least don't motivate the opposite). Business use of SUVs has been abetted over the years by tax rules giving them the superior depreciation treatment accorded trucks, based on weight. No doubt this was a result of lobbying on the part of auto companies enjoying the high profitability of SUVs. Thus it's been cheaper for businesses to use a $30,000 SUV than a $30,000 car. We and our government have to make more responsible decisions.

Finally, in order to make a genuine difference, we must invest on a vast scale in mass transit, energy efficiency and non-petroleum-based energy. This will have short term consequences: some combination of higher taxes, slower growth, reduced government spending in other areas, higher deficits and/or lower consumption levels. We can't spend to solve the energy problem and simultaneously avoid all of these effects. **Does the will exist to do these things in advance of the day we have no alternative?**

Rather than tap the Strategic Petroleum Reserve (which is designated for emergencies, and high prices aren't an emergency), we could add to it. **We could say, "Let's use less than all the oil that's available – and that we can afford – so as to leave some for future generations." But that requires selflessness and farsightedness that's far from in fashion.**

<u>Who'll Own the World?</u>

In addition to the practical and geopolitical ramifications of the energy situation, we'd better consider the financial ones. When the price of oil gapped up in the 1970s, vastly increasing numbers of dollars started to move offshore in exchange for oil. The process of bringing them back came to be called "recycling petrodollars." There are both benefits and risks in this process.

Earlier this month it was reported that our trade deficit declined in June because of rising foreign purchases of our products. That's one of the positive effects of the piling up of dollars abroad, and also of the fact that our goods priced in dollars look cheap to those outside the U.S. In short, we like having buyers for the things we have to sell.

But sometimes we resent their presence. It doesn't take much for xenophobia to rear its ugly head. In the 1980s, there was fear that Japan's economic juggernaut would lead to a wholesale takeover of U.S. assets by Japanese buyers. A couple of years ago, proposed investments by China and Dubai in our oil and port industries were rebuffed, and last fall (before it was clear how desperately we needed more capital), people were grumbling about sovereign wealth funds' growing influence over our financial institutions.

Well, what do you expect to happen? If we spend more than we bring in, and thus send dollars overseas to pay our tab, isn't it reasonable to expect that some will be brought back and spent here? Clearly, the oil producers will have the ability to buy our assets. And some, like Qatar and Abu Dhabi, are far too small for the amounts involved to be invested or spent in those countries without making their inflation worse than it already is.

We're already seeing the effects. Financial institutions ran to sovereign wealth funds when they needed to add to their capital; who else is there? Room rates in hotels around the world are soaring in dollar terms. Powered by foreign buying, prices in the contemporary art market are moving out of sight, and so are high-end real estate prices in London and other cities of choice. Last month it was reported that a villa in the south of France had been sold to a Russian for $750 million: **a great outcome for the seller, but also a sign that eventually we may be priced out of our own assets.**

With dollars moving abroad and exchange rates going against us, Americans are likely to find it harder to afford the goods and the standard of living they're used to, enjoy holidays overseas, and hold on to assets rather than succumbing to bids.

The numbers involved are very substantial. On July 10, *The New York Times* wrote:

> With oil hovering near $140 a barrel, analysts expect countries in the [Persian] gulf to generate yearly cash surpluses of $300 billion . . . with sovereign funds in this area forecast to reach a size of $15 trillion by 2020.

And of course, the numbers will do nothing but increase with time. The other day I was given a shorthand way to think about the situation: for every $1 in the price of a barrel of oil at a point in time, approximately $1 trillion will move from oil consumers to oil producers over the subsequent hundred years. **Oil at $120 means the producers will reap about $120 trillion. To put this into perspective, the total value of the world's stock markets currently stands at about $47 trillion. So it's not much of an exaggeration to say the oil producers could own the world.**

You might argue that more fuel-efficient cars, electric cars, atomic cars, hydrogen power and cold fusion will alter the equation and prevent this massive shift of wealth. And we know for sure that high oil prices will reduce demand, encourage exploration and make invention and substitution economic. **But I think it's smarter to think about the issue than just count on things to work out.**

We're From the Government and We're Here to Help

Last month, in "Doesn't Make Sense," I labeled the obsession with the short term the worst thing about American business. But short-termism is far from limited to business. The process under which we're governed is even worse.

In 2004, the *Los Angeles Times* asked me to write a review of Pete Peterson's excellent book on the looming fiscal crisis, "Running on Empty." One of his messages was that politicians are increasingly loath to take on the big issues of the future. Why should they? The prospects are unpleasant, and any solutions will entail pain. **What politician would trade away votes today to solve problems that are likely to come to a head long after he or she has retired?** As Peterson put it:

> . . . while our problems are not yet intractable, both political parties are increasingly incorrigible. They are not facing our problems, they are running from them. They are locked into a politics of denial, distraction, and self-indulgence that can only be overcome if readers like you take back this country from the ideologues and spin doctors of both the left and the right. . . .
>
> With faith-driven catechisms that are largely impervious to analysis or evidence, and that seem removed from any kind of serious political morality, both political parties have formed an unholy alliance – an undeclared war on the future. An undeclared war, that is, on our children. **From neither party do we hear anything about sacrificing today for a better tomorrow. In some ways, our most formidable challenge may be our leaders' baffling indifference to our fiscal metastasis**. As former Treasury Secretary Larry Summers puts it, "The only thing we have to fear is the lack of fear itself." (Emphasis added)

It doesn't require higher math to see that we face serious problems in areas such as Federal deficits, the balance of payments, international competitiveness, energy, Social Security, Medicare and education. Certainly those problems won't solve themselves. But when did you last hear of any serious debate on them?

Take the Social Security system. There are only four possibilities: (1) higher taxes, (2) lower benefits, (3) privatization, or (4) dealing with the system's insolvency when it occurs. But the first two are unpopular, and the third is politically contentious, given that it's inherently less egalitarian than the current system and could result in the government being on the hook as the payer of last resort. So that leaves the fourth . . . which is where we stay. **This just is not an acceptable approach to problem solving**.

Likewise, everyone knows the tax code is overly complex, indecipherable and larded with provisions benefiting special interests. It desperately needs reworking from the ground up, but no one considers that politically doable.

As *The Wall Street Journal* pointed out on June 24:

> When President Clinton tried to overhaul the health-care system, he couldn't get even a committee vote on his plan in a Congress his party controlled. When President George W. Bush tried to revamp Social Security, he couldn't get even a committee vote on his plan in a Congress his party controlled.

Washington's failure to solve the big problems really gets me going, calling to mind a great quote from Will Rogers: "The more you observe politics, the more you've got to admit that each party is worse than the other."

Condemnation of politicians needn't be universal. There actually are some I like. More than anything else, they're marked by a spirit of bipartisanship. Rather than consider politics a blood sport in which the only important goals are to embarrass the other side and win elections, they want to solve our nation's problems. I just think they're few in number, and much fewer than I recall from my youth.

I confess that I feel the deck is stacked against government getting better. Less attention paid to newspapers and TV news, declining interest in national and international affairs, the rising role of the sound bite, generally shorter attention spans, a vanishing spirit of self-sacrifice, rising me-first-ism . . . where would optimism come from in this regard? We can hope, but I'm not that hopeful. The truth is that most people vote for the candidate who looks and sounds best in TV ads, who says what they want to hear, and who they think will put money in their pocketbooks today and brighten their lives tomorrow.

Imagine two candidates for president. One says, "I'm going to give you eight years of discipline and denial – of higher taxes and lower spending – but I'll leave the country in better shape." The other says, "I have a secret plan that will solve all of our problems without requiring any sacrifice on your part." Who do you think would win?

<u>What Won't Work</u>

There are no simple solutions to these issues. But that's not going to keep simple solutions from being demanded. Two areas where we're likely to see them tried are tax progressiveness and global trade.

A lot of populist rhetoric is coming from certain candidates for office this season, and if they're elected, they might try to redress the income disparity through tax increases at the top. As usual, they'll say, "We're not out to 'soak the rich.' We're just trying to make them pay their fair share." I don't know where the populists will go for their definition of a "fair share," but I'm pretty sure it'll turn out to be just a synonym for "more."

The result would be tax increases on people who – not according to value judgments, but in sheer economic terms – are our most productive citizens. Such increases aren't the answer, and they can affect the economy negatively. Back in Britain's low days in the 1970s, the top income tax rate was in the mid-90s (as was ours when I was a boy), and I read about a banker taking a week off from work to paint his house. The calculus was simple: it was cheaper for him to give up a week of after-tax salary than to pay the painter's bill.

Taxation creates incentives: to work less, to hide income and, ultimately, to relocate income to avoid taxes. When a professional finds it economically attractive to forgo his pay to perform a physical task, the net result is a loss for the aggregate economy. **This isn't the kind of incentive we should be presenting.** What supply-siders did in the 1980s was convince lawmakers of the effect of tax decisions on the operation of the macro economy. Their lesson mustn't be forgotten.

Likewise, trade barriers sound like an easy solution but don't work.

- Operating freely, global trade causes each good to be produced where it can be done cheapest and best. In this way, aggregate efficiency is maximized, and thus so is aggregate societal welfare. Actions that interfere with efficiency and the free-market allocation of resources invariably will have a negative overall effect.
- It's highly unlikely that we can raise barriers and tariffs against others without causing them to retaliate.
- A protectionist decision is just a choice among potential beneficiaries. A ban on imports of cheap clothing, for example, would protect the incomes of Americans working in the garment and textile industries but cause all Americans to pay more for what they wear.

As the last bullet point suggests, taxes and tariffs don't add value or make society better off; they merely represent decisions about how some elements in society are to be treated via-à-vis others. However, by interfering with the free-market allocation of resources, they're highly likely to detract from the overall economy. Bottom line: handle with care.

* * *

The more I think about solving problems, the more I believe one of the crucial choices is with regard to time frame. Short-term answers are very different from long-term answers. **America's problems are long-term in nature and require long-term solutions. There are things that can help in the short term but be counterproductive in the long term, and we mustn't let them get in the way.**

Take the earlier discussion of oil prices. We know high prices discourage consumption and encourage conservation, fuel efficiency, exploration and the development of alternatives, and that low prices do the opposite. When people complain about high prices, vote-hungry politicians rush forward with short-term palliatives. **But quick fixes will do nothing but exacerbate the long-term problem, while short-term pain is probably an essential part of its solution.** In order to bring down oil prices in the long run, we need high oil prices in the short run.

Because gasoline prices were up, Americans drove 12.2 billion (or 5%) fewer miles in June than they did a year earlier. That was the eighth down month in a row. In other words, high prices made people treat energy like the finite and valuable commodity it is. High prices aren't pleasant, but eventually they could help get us to the desired result. **It's not for nothing that they say "no pain, no gain."** (And for this reason, the 20% decline in oil prices over the last six weeks shouldn't be viewed as an unmitigated boon.)

The short-term pleasure principle that seemingly governs today will make it challenging to implement disciplined and possibly painful solutions to the problems enumerated above, but they're the only way forward.

* * *

I hope you'll consider this memo constructive, and that it'll inform or inspire debate. The solutions to the problems I raise aren't obvious and won't come easily. But that's why these things must be tackled by skilled, apolitical problem solvers in and out of government. We need boldness, hard work and resolve from our leaders. **And we need officeholders capable of imagining outcomes worse than losing an election.** I can think of several.

We tend to lurch from crisis to crisis. In difficult times like today, we're too busy putting out fires to pay attention to long-term problems. And then, when the crises recede, people celebrate the return of prosperity and forget about the distant future and the big picture. **We'd all like to not have to face the problems I list. Indeed, we wish they didn't exist. But they do exist, and we must deal with them. And there can't be a better time than the present.**

August 28, 2008

P.s.: I always circulate my memos for comment before they're published, and this time I got a good one from Richard Masson. He's a very thoughtful guy, especially on bigger-picture matters – a bit of a libertarian, but also impossible to pigeonhole. I want you to have the benefit of his response:

> The best thing about our country is the resourcefulness of our citizenry and the flexibility of our institutions and laws. Creative destruction and a functioning market economy assure change toward the best solution over time. I generally agree with all your observations and concerns, but I have faith in our ability to create (rather than impose or legislate) solutions over time. Perhaps America will enjoy a manufacturing renaissance, or the cost of oil will force communities back together and facilitate greater interdependence between neighbors? Perhaps a slowing economy will slow immigration and create job opportunities for our less educated citizens (and youngsters). Perhaps our best and brightest will gravitate toward engineering and science rather than finance. In many ways, the next generation could enjoy a higher quality of life even at a measurably lower standard of living.

I'd love it if Richard turned out to be right.

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Memo to: Oaktree Clients

From: Howard Marks

Re: Nobody Knows

The title of this memo isn't a joke; I mean it. Nobody knows the real significance of the recent events in the financial world, or what the future holds. Everyone has an opinion – there's an off-color joke to that effect – but opinions are entirely different from knowledge. As usual, the bulls are optimistic, the bears are pessimistic, and the rest are uncertain.

This is a great time for my favorite quote from John Kenneth Galbraith: "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." No one knows about the future, and that's more true now than ever . . . literally. Excesses were committed at financial institutions that we've never seen before in terms of their scale or their breadth, and many new inventions are in place that never existed before. So clearly no one can know how things will pan out.

My conviction that this is true frees me from having to methodically assess the strength and weakness of economies and institutions, and it permits me to limit my comments to what I consider strategic realities.

I'm flattered that people have asked for my opinion, and I will give it. But that's all it is: an opinion. In setting it down, I will repeat things I've written before. So if you find something that you think you're reading for the second time, you're probably right.

<u>Boom-Bust</u>

Those two words say it all. If you have a boom, eventually you'll have a bust. And the further the boom goes, the worse the bust is likely to be. If there's no boom, on the other hand, there needn't be a bust.

There was no great boom in the U.S. economy in 2003-07, and that's one of the reasons why it has held up reasonably well despite the recent turmoil.

But there was an incredible boom in the financial sector, and it has led to an incredible bust. (It remains to be seen whether its effects will slop over into the real economy. As you know, we think they will.)

Finally, there wasn't a boom in the U.S. stock market, and so it hasn't busted. (If you think your stocks have given you pain, realize that their decline isn't at all commensurate with the end-of-the-world thinking roiling the financial sector).

How Things Got This Way

Much of the current problem can be attributed to a decades-long bubble in the financial sector that made it the employer of obvious choice; attracted employees who were "the best and the brightest" (although often untrammeled by experience); contributed to greed and risk taking; drove out fear and skepticism; and carried institutions, behavior, expectations and asset prices to unsustainable levels.

What are the factors that got us in the current mess?

- Excess liquidity, which had to find a home.
- Interest rates that had been reduced to stimulate the economy.
- Dissatisfaction with the resulting prospective returns on low-risk investments.
- Inadequate risk aversion, and thus a willingness to step out on the risk curve in search of higher returns.
- A broad-scale willingness to try new things, such as structured products and derivatives, and to employ massive leverage.
- A desire on the part of financial institutions to supplement operating income with profits from proprietary risk taking – that is, to be "more like Goldman."
- A system of disintermediation, selling onward, and slicing and dicing that caused many participants to overlook risk in the belief that it had been engineered away.
- Excessive reliance on rating agencies which were far from competent to cope with the new instruments, and on black-box financial models that extrapolated recent history.
- Unquestioning acceptance of financial platitudes without wondering whether altered circumstances and elevated asset prices had rendered them irrelevant:
    - Houses and condos are good investments and can be counted on to appreciate.
    - Mortgages rarely go into default.
    - There can never be a nation-wide decline in home prices.
    - It's okay to grossly lever a balance sheet if you've hedged enough through derivatives.
    - It's safe to borrow and invest funds equal to a huge multiple of your equity capital if the probabilistic expected value is positive, because "disasters rarely happen."
- Individuals such as mortgage brokers and mortgage borrowers who were given incentives to do the wrong thing.
- Newly minted financial "masters of the universe" encouraged to maximize returns for themselves and their employers without concern for whether they were adding value to the financial system or endangering it.

In general, the above can be summed up as a shortage of adult supervision, common sense, skepticism, ethical concern and good old-fashioned prudence. As often happens in booms, the kids shouldered the adults aside or impressed them too much.

The list of errors can make you laugh . . . or cry. I mentioned in "Hindsight First, Please" how often financial people do things that look downright silly afterwards. But that never stops them from repeating the old mistakes or making new ones.

So now we find financial institutions that endangered themselves by using extensive short-term borrowings or deposits to make investments that turned out to be enormously risky when an unlikely disaster – a nationwide decline in home prices – occurred.

In many ways, changes in the environment contributed as well. They crept up one by one, unnoticed, but their combined effect is significant. For example,

- The Glass-Steagall Act was repealed, permitting banks and investment banks to combine. (It had been enacted in 1933 to outlaw such combinations because they were felt to have contributed to the Crash of '29. It's ironic – and certainly not irrelevant – that it was repealed in 1999, in time to contribute to the current credit crunch.)
- The rule limiting short sales to up-ticks was revoked in July 2007, enabling short selling to force stock prices down unabated.
- Derivatives were created whose prices were determined by the price of their "real" underlying securities; now we see that in an Alice-in-Wonderland way, they're able to influence the price of real securities (see below).
- And mark-to-market accounting exposed precariously leveraged institutions to the risk that technically-driven declines in asset values might leave them too weak to make it through to a better day.

It was during my working lifetime that the phrase "too big to fail" was coined. More recently, Citibank caused some people to observe that it had become too big to manage. In the current go-round, financial institutions have been described as too big to understand and, finally, too big to disentangle (given the proliferation of derivatives and swap transactions, a key element in assessing an institution's essentialness is the degree of counter-party risk it presents to others). There's no doubt that these developments are frightening. But heroes aren't people who're unafraid, but rather those who act bravely despite their fears. Investors mustn't let emotion control their actions.

Because of this combination of altered behavior, financial innovation and changes in the environment, I feel unable to tell you what lies ahead. But that doesn't mean I'm not going to suggest a course of action.

<u>Does the Market Know?</u>

For reasons both systematic and unsystematic, the market is in many cases taking its lead from . . . the market. Price declines cause fear, and thus further price declines.

In some cases, the signal for increased worry comes from increases in the price of credit default swaps, which provide insurance against debt defaults. Rising CDS prices imply that creditors have become more concerned. This can send down the prices of a company's stock and debt instruments and frighten customers and depositors into withdrawing funds, potentially leading to downgrading and failure. In other words, increases in prices for credit insurance can serve as self-fulfilling prophesies. This is the unintended consequence of one of the recent innovations.

I want to mention the potential for manipulation present in this situation. One strong bid for default protection in the thin market for CDS on a given company can massively depress the price of billions of dollars worth of stock and/or debt. Clearly, an unscrupulous short-seller can use this tactic to his advantage. No one knows the extent to which it is in play . . . or how to stop it.

In the end, people once again have to apply skepticism and their own judgment, this time to bad news. Is the market smart or dumb? Is it giving us a valid signal to get out or the buying opportunity of a lifetime? I seem to remember a useful quotation to the effect that "The market is an ass." Thus I think there's more money to be made by being a contrarian than a trend follower.

The End of the Financial System

We're seeing and hearing things today that we never imagined.

- The demise or bailout of Lehman Brothers, Bear Stearns, Freddie Mac, Fannie Mae and AIG.
- Concern about the viability of Goldman Sachs and Morgan Stanley, and huge declines in their stocks.
- Rising prices for CDS protection on U.S. Treasury securities.
- Rates on short-term T-bills close to zero because of an extreme flight to safety.
- Awareness for the first time, I think, that the U.S. government's financial resources are finite, and that there are limits on its ability to run the printing press and solve problems.

Will the financial system melt down, or is this merely the greatest down cycle we've ever seen? My answer is simple: we have no choice but to assume that this isn't the end, but just another cycle to take advantage of.

I must admit it: I say that primarily because it is the only viable position. Here are my reasons:

- It's impossible to assign a high enough probability to the meltdown scenario to justify acting on it.
- Even if you did, there isn't much you could do about it.*
- The things you might do if convinced of a meltdown would turn out to be disastrous if the meltdown didn't occur.

- Most of the time, the end of the world doesn't happen. The rumored collapses due to Black Monday in 1987 and Long-Term Capital Management in 1998 turned out to be just that.

* -- Money has to be someplace; where would you put yours? If you put it in T-bills, what purchasing power would be accorded the dollars in which they're denominated? If the government's finances collapsed, what good would your dollars be, anyway? What depository wouldn't be in danger? If you and many others decided to put billions into gold, what price would you have to pay for it? Where would you store it, and how would you pay for the truck to move it? How would you spend it to buy the things you need? What would people pay you for your gold, and what would they pay you with? And what if you bought credit insurance on all of your holdings: who would be able to make good on your claims?

No, I don't see any viable way to plan for the end of the world. I don't know any more than anyone else about its probability, but I see no use in panicking.

I think the outlook has to be viewed as binary: will the world end or won't it? If you can't say yes, you have to say no and act accordingly. In particular, saying it will end would lead to inaction, while saying it's not going to will permit us to do the things that always have worked in the past.

We will invest on the assumption that it will go on, that companies will make money, that they'll have value, and that buying claims on them at low prices will work in the long run. What alternative is there?

<u>What Kind of Future Do We Face?</u>

Of course, even assuming there will be a recovery, we have to think about what it will look like. As I wrote in "Doesn't Make Sense," we aren't counting on a "V." We will continue to emphasize companies that we feel serve basic economic functions and can do relatively well even in bad times. Many elements in the economy are being damaged, especially confidence, and they may take a relatively long time to recover. In particular, the mechanism for providing capital is in great disrepair, and less credit certainly means a slower recovery and less growth.

The financial institutions deserve a special mention. If there's ever been a sector that's down-and-out, this is probably it. Nevertheless, Oaktree generally demands more transparency in order to invest than most of them provide. It can seem almost impossible to ascertain their condition through due diligence, and absolutely impossible without access to their books. For example, possible buyers probably found the risks at Lehman Brothers to be unanalyzable. As *The Wall Street Journal* said on Tuesday,

> Even understanding Lehman's current trading positions was tough. Lehman's roster of interest-rate swaps (a type of derivative investment) ran about two million strong . . .

What kind of effort would it require to understand the significance of two million derivatives positions: are they thoroughly hedged, or bullish or bearish on balance? And what about Lehman's millions of other derivatives and complex securities? This opacity, combined with heavy leverage, reliance on short-term funds, liquidity and conscious risk taking, is the reason why a loss of confidence is conceivable at any financial institution in times of panic.

What will the Wall Street of the future look like? We read – and I don't doubt – that for at least a while it will be smaller, less leveraged, less profitable, and more highly regulated. But I also think it will be less competitive and less risky.

In the course of my career, Wall Street went from being (1) brokers handling riskless trades for commission to (2) dealers buying and selling inventory for a spread to (3) block traders purchasing large amounts of stock when market liquidity was inadequate to (4) proprietary traders risking their own capital in pursuit of profit for the house. Backing down this progression wouldn't be the worst thing in the world.

<u>What Will Start the Recovery?</u>

Eventually, someone will walk out of the crowd and take advantage of the lows. He may start an investment bank unburdened with a legacy of losing positions. Or a bond insurer like Warren Buffett did when MBIA and Ambac became impaired. **The cause of the recovery can't be predicted. There may not even be a visible one. Maybe things will just get so cheap that they can't stay down.** (In ancient history – November 2001 – I wrote "You Can't Predict; You Can Prepare," with a thorough description of how cycles happen, based on energy all their own. It might be worth digging up.)

I like to point out that, even in retrospect, no one can say what started the collapse of the tech stock bubble in 2000. But it did start . . . just, I think, because stock prices rose far too high. That works in reverse, too.

In March, in "The Tide Goes Out," I mentioned the three stages of a bull market, a notion I've been carrying around in my head for about 35 years:

- the first, when a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone's sure things will get better forever.

As we all know, buying during the first stage can be highly profitable, while buying during the last euphoric stage usually leads to disaster.

Then I went on to create the converse of the above, the three stages of a bear market:

- the first, when just a few prudent investors recognize that, despite the prevailing bullishness, things won't always be rosy,
- the second, when most investors recognize things are deteriorating, and
- the third, when everyone's convinced things can only get worse.

In the final stage, you can buy assets at prices that reflect little or no optimism. There can be no doubt that we are in the third stage with regard to many financial institutions. Not necessarily at the bottom, but in a serious period of unremitting pessimism. **No one seems able to imagine how the current vicious circle will be interrupted. But I think we must assume it will be.**

It must be noted that, just like two years ago, people are accepting as true something that has never held true before. Then, it was the proposition that massively levered balance sheets had been rendered safe by the miracle of financial engineering. Today, it's the non-viability of the essential financial sector and its greatest institutions.

Everyone was happy to buy 18-24-36 months ago, when the horizon was cloudless and asset prices were sky-high. Now, with heretofore unimaginable risks on the table and priced in, it's appropriate to sniff around for bargains: the babies that are being thrown out with the bath water. We're on the case.

September 19, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: Plan B

Over the last decade or two, Plan A consisted of relying on the free market to maximize economic growth and efficiency (as described in "The Aviary," May 2008). What can we say about that? Oops? We don't hear much at this moment about market efficiency, or about the proposition that it would cause complex mortgage-backed securities to be priced right.

So now we have Plan B, better known as TARP, the Troubled Asset Relief Program. On the heels of other injections of capital by the U.S. Treasury and Fed and central banks elsewhere, it was proposed on Friday that up to $700 billion be spent to purchase "toxic" mortgage securities from financial institutions that are weighed down with them.

Ya' Gotta Believe

Those who have more money than they need lend it to those with use for more money than they have. This process is called providing credit. The movement of credit puts otherwise-idle money to work and thus adds to economic output. Economies run on credit.

According to Merriam-Webster, the word "credit" is derived from the Latin *credere*: "to believe, entrust." We provide credit when we believe in borrowers and trust that they'll pay us back (although we believe in some more than others and charge the latter more interest). Further, the entire economy runs on trust: that the people to whom we provide goods and services will pay their bills; that contracts will be adhered to; and that money will retain value, or at least the part that inflation doesn't erode.

Belief is what makes the economic world go round. Take a minute to think about how we would behave in a world in which there wasn't trust in money, the institutions that store it and the mechanisms that move it from one place to another. Clearly, we'd be sunk without trust in the financial system.

I've described in the past how financial institutions are vulnerable to loss of faith because of their unique combination of opacity, leverage, conscious risk bearing, and their use of short-term deposits and borrowings to fund longer-term, illiquid assets. When providers of capital lose faith in a financial institution, they line up to withdraw their money. But the institution can't give them all back their money, because it can't liquify all of its assets immediately. Attempts to do so increase the downward pressure on asset prices, further weakening financial positions and reinforcing the loss of faith. And thus the circle becomes vicious and we have a "run on the bank."

We saw many runs on banks during the Great Depression; the result was the introduction of federal deposit insurance. We also saw a bank run in the U.K. last year, when depositors lined up at the Northern Rock building society until the Bank of England calmed fears by guaranteeing all deposits. (I had money there, and believe me, absent the guarantee, the 2% penalty for early withdrawals would have been powerless to dissuade me from moving the remaining 98% to a safer institution. Take a few hundred or thousand of me, and you have a run on the bank.)

In short, the government is attempting to prevent a loss of belief. Is such a thing possible? Ask yourself whether eight months ago you thought possible this year's developments at Bear Stearns, IndyMac, Lehman Brothers, AIG, Fannie Mae and Freddie Mac. To some extent, they all stemmed from a loss of faith.

The Source of the Problem

There are two principal fundamental causes behind the events we're seeing. The first is the huge losses in complex mortgage-backed securities. As I've written before, the issuance and purchase of these securities resulted from the following confluence of factors:

- Quest for return, decline in risk aversion and lowering of skepticism.
- A boom in home prices and a belief that they couldn't fall back *en masse*.
- Securitization and selling onward of debt – which eliminated lenders' hesitance to lend and led to a process in which everyone profited when a loan was made.
- Thus an increased willingness to lend higher percentages of the skyrocketing prices of homes, even where the borrower couldn't demonstrate creditworthiness.
- Widespread use of leverage (because the risks were underrated) and complexity in fashioning mortgage-backed securities.
- Massive shortcomings at rating agencies that erroneously described the resulting securities as investment grade, and sometimes even "super senior."

In this way, enormous amounts of overrated securities came to the market. They went to financial institutions that didn't understand the riskiness of what they were buying and thus permitted themselves to become vastly overleveraged.

I'll keep it simple. Suppose you have $1 million in equity capital. You borrow $29 million and buy $30 million of mortgage loans. Twenty percent (or $6 million) of the mortgages go into default, and the recovery on them turns out to be only two-thirds ($4 million). Thus you've lost $2 million . . . your equity capital twice over. Now you have equity capital of minus $1 million, with assets of $28 million and debt of $29 million. Everyone realizes that there'll be nothing left for the people who're last in line to withdraw their money, so there's a run on the bank. And you slide into bankruptcy.

Because of the high regard in which financial institutions were held; because of the implied government backing of Fannie Mae and Freddie Mac; and because permissible leverage increased over time, financial institutions' equity capital was permitted to become highly inadequate given the riskiness of the assets they held. Or perhaps I should say institutions took on too many risky assets given the limitations of their equity capital. That, in a nutshell, is why institutions have disappeared.

The second fundamental factor leading up to the current mess was the creation of the vast market in derivatives, especially credit default swaps (CDS). In the current decade, CDS came into broad use as a mechanism for insuring against defaults. For an up-front fee and an annual premium, holders of debt could get someone else to promise that they'd buy that debt at face value in the case of a default or other "credit event."

The buyers of CDS accepted at face value that the writers of the insurance would pay if there was a default. For this reason, because Bank A had bought insurance on Company X's debt from Hedge Fund B, it considered it safe to sell insurance to Bank C. **But what if X defaults and A has to pay C but can't collect from B?** There's over $60 trillion of CDS outstanding, and a lot of it is well hedged in theory; thus the net exposure to defaults if everyone pays might be rather small. But if some counterparties are unable to pay, institutions that bought insurance from them (or from others that bought from those institutions) might fail to receive billions in payments. Consider it one big daisy chain. It's probably because of its position as a counterparty that Bear Stearns wasn't permitted to fail in March (while Lehman was cut adrift this month when its failure was judged to be bearable).

Of course, these two developments have been complicated by (a) the fact that no one can reasonably say what the home underlying a mortgage is worth (the intrinsic value of a non-cash-producing asset is a useless concept in the short run), (b) the fact that no one knows how the credit swap market will function in a crisis, and (c) their own sheer magnitude. The sum of the foregoing has the potential to place in jeopardy any financial institution that lacks federal backing. It's for this reason that the government has assumed the liabilities of Fannie Mae and Freddie Mac, lent money to AIG, accepted Goldman Sachs and Morgan Stanley as bank holding companies (with permanent access to Fed borrowings), backstopped money market funds, and now proposes to purchase $700 billion of mortgage securities.

Does Ben Know Something We Don't?

I cited the above headline in "Now What?" last January. That's what *breakingviews.com* asked about the Fed's September 2007 decision to cut rates by 50 basis points rather than the expected 25. Clearly Fed Chairman Ben Bernanke thought the circumstances called for stronger medicine than most observers.

Now it's clear that both Bernanke and Treasury Secretary Hank Paulson envision possible consequences justifying the strongest possible action. Last weekend, for example, Paulson said in an interview, "I don't like the fact that we have to do this. I hate the fact that we have to do it. **But it's better than the alternative**." (Emphasis added)

What is the alternative? As I suggested last week in "Nobody Knows," there really is no outcome so negative that it can't be imagined. That doesn't mean terrible things will happen if no action is taken, but the possibilities are there, causing fear. Obviously, Bernanke and Paulson feel some of them could come to pass, and I respect their opinion.

So what is that alternative Paulson alludes to? Cascading bank failures? Interlocking dependence on counterparties in the derivatives markets who lack the ability to make good on their liabilities? Ultimately, reduced faith in U.S. Treasury securities and the dollar? As I said last week, I don't know. But it's not unreasonable to respect these possibilities. Our leaders want to justify the strongest action in history without spooking the market by enumerating the possibilities, so they're not being too specific. The Great Depression is our only model. I believe it justifies strong action.

Let me take a moment to say we're enormously lucky to have the right team in place at this time. Bernanke is a highly respected academic expert on the Great Depression, and Paulson is the very successful practitioner who chaired Goldman Sachs, an institution for which I have enormous respect. Being human, they're unlikely to get it all right. But I can't think of anyone I'd rather have in their jobs.

The Plan and the Stumbling Blocks

The plan is simple. In fact, to some it's too un-bureaucratic to be acceptable. The Treasury will use up to $700 billion to purchase the most toxic mortgage-backed securities from financial institutions – both U.S. and foreign – that do business in the U.S. This will reduce the doubt about the institutions' solvency and, in place of unsalable assets, give them cash they can lend. No external oversight or internal process is specified, and the result will be immune from examination by other authorities and from litigation.

Having described the plan in one paragraph, it'll take much more space to discuss the complaints being voiced and the obstacles in its path.

- We're asked to trust the judgment and integrity of the Treasury Department. I find this a pragmatic and direct solution. Others more skeptical than me disagree. Some think Paulson will be biased in favor of Goldman Sachs and the rest of Wall Street, but I'm convinced he took the job out of *noblesse oblige* – not for money or fun, I think – and I trust him to do his level best.

On that subject, let me share a little history. Fifteen years ago, the staff of the Resolution Trust Company asked if we could help them achieve fair prices in disposing of the assets they'd taken on from failed S&Ls. I outlined a plan under which brokers would be asked for bids and we would watch the brokers, judging the adequacy of those bids. **"But who'll watch you," they asked.** My reply: "I've got bad news: you're going to have to trust someone." I'm perfectly happy trusting the Paulson-led Treasury.

- In a similar vein, some are complaining about the lack of supervision in the plan. The *Financial Times* quoted Barack Obama as saying, "We cannot give a blank check to Washington with no oversight or accountability . . ." Well, for my part, I'd rather entrust power to one wise man than a committee or bureaucracy consisting of average people. I think Paulson is that one wise man, but I'm also sure he's smart enough to surround himself with others who are equally capable.

- What will the marching orders be? In particular, what sort of prices will be paid? Fair market prices or higher? First of all, it's almost impossible to come up with a fair or "market" price for many of these assets today. Second, paying just the market price in the current highly depressed market wouldn't do much for the institutions' net capital position. But third, if more than the market price is paid, that'll be seen as a "giveaway to Wall Street." **It has to be made explicit – to those expected to approve the plan, and certainly to those expected to carry it out – whether these will be straight sales at market or they'll include a subsidy**. I think a bunch of the latter is called for.

- **Even beyond the points listed above, another issue may present a bigger stumbling block. The greatest reluctance may relate to the fact that, under the plan, when the process restores the viability of institutions that now are burdened with negative book value and inadequate confidence, the immediate financial benefits would go to shareholders and executives who either participated in the creation of the problem or, at any rate, should be penalized for the companies' failings.**

  To solve the problem, some say that in exchange for taking securities off institutions' hands – especially at above-market prices – the government should get ownership positions in those institutions. But how much? What would be the proper quid pro quo? If a $1 billion purchase of debt at $200 million above market saved a $15 billion institution, what piece of the company should the government receive? Do we want the government owning large pieces of private companies, or running them? And would that ownership stake then put the government in a conflict position vis-à-vis the institutions where it's not an owner? This is obviously a complex issue, and I'd hate to see it delay the solution of the problems we face.

  Further, there are calls for requiring executives at the institutions involved to accept limits on their compensation. What could be worse than setting up reasons for people to hesitate before reaching for this lifeline?

- Certainly politics will be a major factor in whether the plan is enacted and in what form. In that regard, **there couldn't be a worse time for this to be debated than six weeks before the election.**

  After being well ahead in the polls until late August, Barack Obama lost his lead when the Republicans held their convention and made Sarah Palin their vice presidential candidate. But last week, when the economic crisis exploded and John McCain described the economy as strong, the Democrats pulled back into the lead. That's not lost on them, and I'm sure they'll continue to use the issue to maximum advantage. They'll complain about the one-sidedness of the Wall Street bailout and demand something for "the rest of us," like further economic stimulus, direct relief for mortgage borrowers, and loans to the auto makers. This politicizing might delay the process, encumber it with baggage, or make it unattractive to its supporters.

  Democrats will attack the plan to make Republicans look bad, and conservative Republicans may resist it as an unwarranted extension of the government's reach. In the end I feel it'll pass, but who knows in what form.

I don't view the plan as mainly a bailout for Wall Street and fat cats. Saving the financial system will benefit all users of capital, including home buyers and auto makers. Of course, that may sound like "trickle-down economics," which some are happy to rail against.

I think federal ownership would be a very hairy matter. But in this case I do have a solution, at least regarding the prices at which the government resells the debt: **Why not simply say that the government should receive half of the buyers' return in excess of a 20% yearly rate,** or some such? Ownership would present challenges, but sharing in the benefit would not.

<u>Who's In the Wrong?</u>

There'll be cries for scalps, and politicians will play to the crowd by assigning blame. This should be primarily a side-show, but it can grow into a significant distraction.

Short sellers are in the crosshairs most prominently. It is a simple fact that ever since the up-tick rule was revoked fourteen months ago, short sellers have had the ability to drive down stock prices, which they couldn't do if a short sale could only take place at a price higher than the last trade. It's also a fact that some financial stocks have fallen, and that their declines have added to worries about the companies, inducing further declines. Of course, no connection between the two has yet been proved.

As a result of the recent market action, short selling was outlawed in roughly 800 financial stocks, including outliers such as General Electric. This action was coincident with last Friday's rally, and people breathed a sigh of relief. Had short sellers been responsible for the demise of Lehman? Should short selling be banned? As usual, the answer isn't clear.

Balancing out the simple truths stated above, a number of factors argue in favor of short selling or against a ban:

- Short selling isn't "worse" than outright buying. One makes stocks go down; the other makes them go up. Why is shorting – selling what you don't own – any worse than buying what you don't own?
- Short selling is a highly legitimate way for investors to act on their belief that a stock's price is too high. Thus it tends to help stocks sell at fair prices.
- Short selling can bring losses to those who hold stock, but unabated buying can force stock prices to too-high levels where no one should buy. What can we do to prevent injury from purchases during unjustified booms?
- **Sure you can keep stock prices from being forced down by outlawing short selling. But then why not outlaw all selling? Think of what that would do for stock prices!**

In the short run, protecting the financial system is more important than preserving market efficiency or heeding the above arguments. Thus I do not think it was a mistake to ban short selling for the time being.

In the long run, however, I feel a ban on short selling is not in order, although I consider it desirable for the up-tick rule to be brought back.

Finally, as with many other things, the real problem isn't with short selling, but with abusive short selling. Manipulating the market to make short positions profitable by spreading negative rumors or bidding up CDS (see "Nobody Knows" from last week) should be driven out . . . although doing so won't be easy.

* * *

The trouble with memo writing at times like these is that there's always more. But this is a good time to wrap up regarding the Treasury's plan. My conclusions are as follows:

In the period 2003-07, the government, and especially the Fed, stimulated the economy and the financial system when they should have been acting restrictively to curb excesses. On the contrary, stimulation is in order today to prevent serious damage. I think we're going to get it.

But I also expect to see a rising tide of regulation of financial institutions in the period ahead, and I don't think restrictiveness will be the right thing until the system is on a firm footing. It's widely agreed that the authorities contributed to the severity of the

Depression by withdrawing liquidity when they should have been increasing it. Let's not tighten again.

In "Doesn't Make Sense" in July, I listed four things that have to happen in order for the trends in mortgages and financial institutions to turn positive:

- Home prices have to stop going down.
- Home mortgages have to be made available.
- Financial institutions have to stop experiencing incremental write-offs.
- Financial institutions have to be able to raise additional capital with which to rebuild their balance sheets.

I also pointed to the complication: that each of these four things is dependent on the occurrence of another. **The good news is that the Treasury plan has the potential to break into the cycle of negativity, directly address the third and fourth of these, and thus contribute to the first and second. That's why I'm all for it.**

In the Depression, the engine of capital provision went into a long-term stall, and we know the consequences. The attempt now is to jump-start processes that have stalled and prevent the rest from doing so. I'm sure this is the right thing to do, and I hope for its success.

September 24, 2008

P.s., In "You Can't Predict. You Can Prepare." (November 2001), I described the process through which stock markets pull out of declines and turn upward:

> Stocks are cheapest when everything looks grim. The depressing outlook keeps them there, and only a few astute and daring bargain hunters are willing to take new positions. Maybe their buying attracts some attention, or maybe the outlook turns a little less depressing, but for one reason or another, the market starts moving up.

In the latest development, it was announced yesterday that Berkshire Hathaway would invest $5 billion in Goldman Sachs stock. Warren Buffett exemplifies the kind of person who can step out of the crowd. **Perhaps his example can make a few more people stop worrying about losing money and start worrying about missing out on gains.** One of these days, that'll happen, and things will turn for the better.

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Limits to Negativism

The markets acted on Monday as if the credit crisis is behind us – how incredible it is to be able to even write those words, whether true or not. Whichever is the case, however, it's important to reflect on what can be learned from the recent events. (I developed these thoughts last week but just wasn't quick enough to turn them into a memo. So I'm reduced to discussing what we all hope is history rather than displaying foresight.)

The Swing of Psychology

The last few weeks witnessed the greatest panic I've ever seen, as measured by its severity, the range of assets affected, its worldwide scope and the negativity of the accompanying tales of doom. I've been through market crashes before, but none attributed to the coming collapse of the world financial system.

It's worth noting that few of the recent sharp price declines were associated with weakness in the depreciating assets or the companies behind them. Rather, they were the result of market conditions brought on by psychology, technical developments and their interconnection. The worst of them reflected a spiral of declining security prices, mark-to-market tests, capital inadequacy, margin calls, forced selling and failures.

It was readily apparent that such a spiral was underway, and no one could see how or when it might end. **That was really the problem: no scenario was too negative to be credible, and any scenario incorporating an element of optimism was dismissed as Pollyannaish.**

There was an element of truth in this, of course: nothing was impossible. **But in dealing with the future, we must think about two things: (a) what might happen and (b) the probability it will happen.**

During the crisis, lots of bad things seemed possible, but that didn't mean they were going to happen. In times of crisis, people fail to make that distinction. Since we never know much about what the future holds – and in a crisis, with careening causes and consequences, certainly less than ever – we must decide which side of the debate is more likely to be profitable (or less likely to be wrong).

For forty years I've seen the manic-depressive cycle of investor psychology swing crazily: between fear and greed – we all know the refrain – but also between optimism and pessimism, and between credulity and skepticism. In general, following the beliefs of the herd – and swinging with the pendulum – will give you average performance in the long run and can get you killed at the extremes.

Two or three years ago, the world was so different as to be almost beyond remembering. It was ruled by greed, optimism and credulity. **In short, it was the opposite of the last few weeks: no story was too positive to be believed.**

- "There's a worldwide 'wall of liquidity' that can never dry up."
- "Triple-A CDOs are as safe as triple-A corporate debt but will deliver higher returns."
- "Leverage holds the key to better investment results."
- "Tranching and selling onward are spreading the risk, thereby eliminating it."
- "Decoupling has reduced nations' economic reliance on the U.S."

Boy, what a good time that was for a dose of skepticism! What benefits it could have provided (in terms of losses avoided). But when conventional wisdom is rosy, few can stand against it. People who do so too early look woefully wrong and are swept aside. That discourages others from trying the same thing, even as the cycle swings further to the positive extreme.

The Black Swan

You may recall that in "The Aviary" in May, I wrote about *The Black Swan*, the second book from Nassim Nicholas Taleb, author of *Fooled by Randomness*. In *The Black Swan*, Taleb talks about unlikely, extreme, unpredictable events that have the potential for dramatic impact. His title was derived from the fact that, never having traveled to Australia and seen its black swans, Europeans of a few centuries ago were convinced all swans were white. In other words, because they'd never seen something, they considered it impossible.

The message of *The Black Swan* is how important it is to realize that the things everyone rules out can still come to pass. That might be generalized into an understanding of the importance of skepticism.

I'd define skepticism as not believing what you're told or what "everyone" considers true. In my opinion, it's one of the most important requirements for successful investing. If you believe the story everyone else believes, you'll do what they do. Usually you'll buy at high prices and sell at lows. You'll fall for tales of the "silver bullet" capable of delivering high returns without risk. You'll buy what's been doing well and sell what's been doing poorly. And you'll suffer losses in crashes and miss out when things recover from bottoms. **In other words, you'll be a conformist, not a maverick (an overused word these days); a follower, not a contrarian.**

Skepticism is what it takes to look behind a balance sheet, the latest miracle of financial engineering or the can't-miss story. The idea being marketed by an investment banker or broker has been prettied up for presentation. And usually it's been doing well, making the tale more credible. **Only a skeptic can separate the things that sound good and are from the things that sound good and aren't.** The best investors I know exemplify this trait. It's an absolute necessity.

The White Swan

Most people probably took away from *The Black Swan* the same lessons I did (and the lessons mentioned in "The Aviary"): "unlikely" isn't the same as "impossible," and it's essential for investors to be able to get through the low spots.

Of course, it's improbable events that brought on the credit crisis. Lots of bad things happened that had been considered unlikely (if not impossible), and they happened at the same time, to investors who'd taken on significant leverage. So the easy explanation is that the people who were hurt in the credit crisis hadn't been skeptical – or pessimistic – enough.

But that triggered an epiphany: **Skepticism and pessimism aren't synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive.** I'll write some more on the subject, but it's really as simple as that.

Contrarianism – doing the opposite of what others do, or "leaning against the wind" – is essential for investment success. But as the credit crisis reached a peak last week, people succumbed to the wind rather than resisting. **I found very few who were optimistic; most were pessimistic to some degree**. Some became genuinely depressed – even a few great investors I know. Increasingly negative tales of the coming meltdown were exchanged via email. No one applied skepticism, or said "that horror story's unlikely to be true." Pessimism fed on itself. People's only concern was bullet-proofing their portfolios to get through the coming collapse, or raising enough cash to meet redemptions. The one thing they weren't doing last week was making aggressive bids for securities. So prices fell and fell – the old expression is "gapped down" – several points at a time.

The key – as usual – was to become skeptical of what "everyone" was saying and doing. One might have said, "Sure, the negative story may turn out to be true, but certainly it's priced into the market. So there's little to be gained from betting on it. On the other hand, if it turns out not to be true, the appreciation from today's depressed levels will be enormous. I buy!" **The negative story may have looked compelling, but it's the positive story – which few believed – that held, and still holds, the greater potential for profit.**

The Future

I write a lot to dissect and explain past events, but I'll try here to make a contribution by taking the riskier path of talking about the future. What do I see?

As for the short term, it's been amply demonstrated that governments and central banks will do everything they can to resolve the credit crisis. No stone will go unturned, and few options will be declined. Most people now believe that letting Lehman Brothers go was a big mistake: as a result of a calculated decision, discipline took precedence over rescue. The results were disastrous, as the commercial paper market froze up, money market funds "broke the buck," and the crisis was ratcheted up several notches.

Most people don't repeat their mistakes; they make new ones. So we should expect that all key players will be rescued in the period ahead. Some elements of that effort will be mistakes, but at least those mistakes won't pull down the financial system. Morgan Stanley was the next big worry but, after Lehman, it became unlikely that Morgan would be allowed to fail. I was asked, "Will the U.S. government guarantee a capital investment made by a Japanese institution?" Absolutely, if that's what it takes. It beats the U.S. having to put up its own money.

The sums being thrown around are the biggest ever: hundreds of billions, adding up to trillions. But there's no hesitation: everything will be done. That doesn't mean it has to work, but it's likely to.

Walter Wriston led Citibank from 1967 to 1984, all but my final year there. He was the world's leading banker and a great guy. One of his most famous observations was, "countries don't go bust." I assume he was making reference to their ownership of printing presses, and thus their unlimited ability to pay their local-currency obligations. That's the main reason why we shouldn't expect there to be any limit on the resources thrown at the problem. All it will take is running the printing presses long enough to rebuild financial institutions' capital accounts, make good guarantees and enable borrowers to roll over their outstanding debt, all of which is reckoned in nominal terms. **The philosophical bridge of unlimited aid to private institutions appears to have been crossed, and printing the necessary money is unlikely to be an issue.**

Of course, that doesn't mean we're out of the woods. **Creating money isn't the end of the story.** What will be the effect?

First, the people who have money have to make the decision to lend to those who need it to fund their businesses. The Fed's provision of capital to financial institutions – even at ultra-low interest rates – isn't enough. If banks borrow money cheaply and lend it to people who don't repay them, they'll be out a lot of low-cost capital. And if they're on the hook for repaying the Fed, they'll be way behind. Because of residual conservatism, the steps so far might have the ineffectiveness of "pushing on a string," something I mentioned in "Now What?" in January. We still have to see money begin to circulate throughout the system.

Jim Grant, the creator of *Grant's Interest Rate Observer,* uses a great phrase to describe liquidity and credit: "money of the mind." Unlike actual currency, it grows and shrinks depending on people's moods – we've just seen a great demonstration. So it's not enough for the Fed to give money to financial institutions; they have to be convinced to provide liquidity and credit.

In recent times, the Fed has provided a lot of capital to banks, but it has also taken in a lot of deposits from banks. We want to see the Fed's advance reloaned, not put on deposit. That's what it'll take to restart the credit machine.

Even when credit starts flowing again, however, I doubt things will return immediately to their old pace. Losses have been taken and capital destroyed, and more losses may still be incoming (ask yourself if home prices are finished going down). More importantly, psyches have been damaged: consumer psychology, lenders' willingness, even investor confidence – all have taken a beating. I doubt if things will bounce right back. There just won't be the same expansiveness. I'll stick with what I said in "Now What?"

> Undoubtedly, credit will be harder to obtain. Economic growth will slow: the question is whether it will remain slightly positive or go negative, satisfying the requirement for the label "recession." Regardless, positive thinking and thus risk taking are likely to be diminished. All I can say for sure is that the world will be less rosy in financial terms, and results are likely to be less positive than they otherwise would have been.

<u>Awash in Money</u>

In the longer term, we have to wonder about the effect on the world of a glut of newly printed dollars, sterling and euros. The reason owning printing presses makes repayment easy is that it lets a nation cheapen its currency. But one would think that more units of currency per unit of GDP means a debasement of the currency, and thus reduced purchasing power (read: higher inflation).

Walking along Hyde Park on Sunday, I saw a street vendor selling old stock certificates. Do you have any banknotes, I asked? Anything from the Weimar Republic? For the last few weeks, I've wanted to get some of those.

In Weimar Germany, the government enabled itself to pay World War I reparations by cheapening its currency . . . literally. So the 1,000 mark note I bought was simply over-stamped One Million Marks in red. Voila! Now we're all rich.

The mark fell from 60 to the U.S. dollar in early 1921 to 320 to the dollar in early 1922 and 8,000 to the dollar by the end of 1922. It's hard to believe, but according to Wikipedia (user-maintained and perhaps not always the most authoritative):

> In December 1923 the exchange rate was 4,200,000,000,000 Marks to 1 U.S. dollar. In 1923, the rate of inflation hit 3.25 x 10^6 percent per month (prices double every two days).
>
> One of the firms printing these [new 100 trillion Mark] notes submitted an invoice for 32,776,899,763,734,490,417.05 (3.28 x 10^{19}, or 33 quintillion) Marks. [That's not a misprint.]

Lord Keynes judged the situation this way:

> The inflationism of the currency systems of Europe has proceeded to extraordinary lengths. The various belligerent governments, unable, or too timid or too short-sighted to secure from loans or taxes the resources they required, have printed notes for the balance.

But it's not that easy. People with things to sell aren't that stupid. So instead of 1,000 marks, a goat now costs one million marks. That piece of paper used to be a thousand mark note – and now it's a million mark note – but it still buys the same goat.

The benefit to the government is that it's able to pay off its old nominal debts in currency of which it suddenly has a lot more . . . but which no longer has much purchasing power. So when repaid in the cheapened currency in 1923, the person to whom the government owed 1,000 marks can only buy one-thousandth of a goat – not a whole goat as in 1920.

My late friend Henry Reichmann was a boy then, working as a busboy in a restaurant in Berlin. He told me he used to be paid at lunchtime and immediately ran out to spend his salary, since it would buy less if he waited until after work to shop.

That's hyperinflation. Just as the Great Depression became a model during the credit crisis, Weimar Germany gives us something to think about regarding our new future. **I'm not smart enough to know what's coming, but I'm also not dumb enough to think a few government actions on Monday were enough to solve all our problems.** At best, we usually substitute one problem for another – usually one later on in lieu of today's.

I don't know what to do about this risk, whether it'll come home to roost, or to what extent. And I certainly don't think hyperinflation can be assigned a high enough probability to make it worth doing much about. But it may cause one to rethink holdings of low-yielding, flight-to-quality-elevated, long-term Treasurys.

The New Financial Order

My daughter Jane – the artistic member of the family – has developed a strong interest in politics and economics of late. (I think this is happening to young people all across the U.S., and it's a very favorable development.) On Saturday she called to ask what I thought about government ownership of banks.

First, I said, I thought it could make an important contribution to solving the short-term problem, and that's good.

Second, however, the U.S. has a strong tradition of government non-involvement in business, and we'd probably like to see it stay that way. "Nationalization" is a much dirtier word in America than in most other places (*International Herald Tribune* headline, October 14 – "Nationalization rule: Do it, but don't say it"). My preference, I told Jane, is for free enterprise with some adult supervision. When we make fundamental changes in the system, it's hard to foresee all the consequences. Consider these questions:

- Will legislators push bankers to make more loans to their constituents (remember Fannie and Freddie)?
- Will the banks have to lend to everyone, even weak borrowers? Will they be allowed to reject any applicants?
- Will they be prevented from foreclosing when mortgages are unpaid?
- Will they be deterred from financing "anti-social" investments like leveraged buyouts?
- Will they be limited in compensating executives? Will that make them less attractive as employers?
- Will bank employees worry about being penalized for errors of commission but not errors of omission?
- If so, will banks be staffed by people who are overly risk-averse? Will they lean toward saying "no"?
- Will capital be harder to come by, especially for smaller, younger companies?
- Will economic growth be slower than it otherwise would have been?
- Will non-government-owned banks be at a disadvantage because, as weaker credits, they'll have to pay more than the competition for their capital?

No one knows, but these questions deserve consideration. **Here's the underlying question: if the government's equity is non-voting, will that be enough to keep it out of the banks' affairs? It's far too soon to say (and hard to be completely optimistic).**

I continue to believe the financial sector of the future will be less leveraged, less risk-prone, less profitable, slower growing and more regulated. And that'll make it less exciting, less glamorous and less the employer of choice. But the beauty of the free-market system is that most developments entail plusses as well as minuses. **I've believed for many years that just as success carries within itself the seeds of failure (see 2003-08), so does failure carry the seeds of success.**

If the banks are made more bureaucratic and risk-averse – and less aggressive and competitive – I'm sure independent boutiques will arise and prosper. The model I have in mind is a forest fire: a year after, bright green shoots grow from the ashes; in fact, I think they're fertilized by the ashes. Think what a landscape like that means for advisory firms like Moelis, Evercore, Gleacher and Greenhill.

In a free-market environment, not even a good knock can keep aggressive people from responding to opportunities. The financial sector will look very different in ten years from what it was a year ago – and that won't be all bad.

* * *

I find that I often end with a quote from Warren Buffett, and often it's the same one:

> The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.

But now I want to talk about the flip side: **When others conduct their affairs with excessive negativism, it's worth being positive.** When others love 'em, we should hate 'em. But when others hate 'em, we can love 'em.

In "The Tide Goes Out" in March, I listed the stages of both bull and bear markets. I said that in the terminal third stage of a bull market, everyone is convinced things will get better forever. The folly of joining that consensus is obvious; people who invest thinking there'll never be anything to worry about are sure to get hurt.

In the third stage of a bear market, on the other hand, everyone agrees things can only get worse. The risk in that – in terms of opportunity costs, or forgone profits – is equally clear**. There's no doubt in my mind that the bear market reached the third stage last week. That doesn't mean it can't decline further, or that a bull market's about to start. But it does mean the negatives are on the table, optimism is thoroughly lacking, and the greater long-term risk probably lies in not investing.**

The excesses, mistakes and foolishness of the 2003-2007 upward leg of the cycle were the greatest I've ever witnessed. So has been the resulting panic. The damage that's been done to security prices may be enough to correct for those excesses – or too much or too little. But certainly it's a good time to pick among the rubble.

* * *

I want to take this opportunity to congratulate and thank my Oaktree colleagues for their ongoing steadfastness. There's a simple formula for taking maximum advantage of opportunities in a collapsing market:

(a) have a firm, well-reasoned estimate of an asset's intrinsic value;
(b) recognize when the asset's price falls below its value, and buy;
(c) average down if the price goes lower; and
(d) be right about the value.

Acumen and resolve are **both** essential. My colleagues continue to show both. In recent weeks our list of purchases has been long most days, and our list of sales almost non-existent. Where there's cash we've put a lot to work, averaging down aggressively, in what we think are great buys.

I also want to thank our clients for trusting us and sticking with us. As Bruce Karsh and I wrote ten days ago in a memo to investors in our Opportunities Funds for distressed debt, ". . . in a few years we'll reminisce together about how easy it was to take advantage of the bargains of 2008-09." Whether or not the worst of the crisis is now truly behind us, I continue to feel that way.

October 15, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: Volatility + Leverage = Dynamite

Nearly fifteen years ago, in April 1994 – at a time when absolutely no one was reading my memos – I published one called "Risk in Today's Markets Revisited." That's when I first proposed the formula shown above. I recycled it in "Genius Isn't Enough," on the subject of Long-Term Capital Management (October 1998).

The last few years have provided a great demonstration of how dangerous it can be to combine leverage with risky assets, and that's the subject of this memo. It'll also pick up on some ideas from my last memo, "The Limits to Negativism."

My memo "Plan B" on the bailout proposal went out on September 24, and as I lay in bed later that night, I realized that I hadn't taken one part of it nearly far enough. In discussing a prime cause of the credit crisis, I wrote the following:

> I'll keep it simple. Suppose you have $1 million in equity capital. You borrow $29 million and buy $30 million of mortgage loans. Twenty percent (or $6 million) of the mortgages go into default, and the recovery on them turns out to be only two-thirds ($4 million). Thus you've lost $2 million . . . your equity capital twice over. Now you have equity capital of minus $1 million, with assets of $28 million and debt of $29 million. Everyone realizes that there'll be nothing left for the people who're last in line to withdraw their money, so there's a run on the bank. And you slide into bankruptcy.

That's true as far as it goes, but I'm going to devote this memo to things which could have followed that paragraph.

The Problem at Financial Institutions

It's no coincidence that today's financial crisis was kicked off at highly leveraged banks and investment banks. The paragraph above shows why that's true, and why the problem is as big as it is. As I wrote in "Plan B":

> Because of the high regard in which financial institutions were held; because of the implied government backing of Fannie Mae and Freddie Mac; and because permissible leverage increased over time, financial institutions' equity capital was permitted to become highly inadequate given the riskiness of the assets they held. Or perhaps I should say

> institutions took on too many risky assets given the limitations of their equity capital. That, in a nutshell, is why institutions have disappeared.

So what exactly did these institutions do wrong? Here are a few examples, using Bank X, with $10 billion of capital, to illustrate:

- Bank X uses leverage to buy $100 billion of triple-A mortgage-related debt, under the assumption that it can't lose more than 1%. Instead, home prices decline nationwide, causing it to write down its holdings by 10%, or $10 billion. Its capital is gone.

- Alternatively (but in fact probably simultaneously), Bank X sells Hedge Fund G $10 billion of credit default swaps on the bonds of Company A, and it buys $10 billion of the same credit protection from Investment Bank H. Company A goes bankrupt, and Bank X pays Hedge Fund G $10 billion. But Investment Bank H goes bankrupt, too, so Bank X can't collect the $10 billion it's due. Its capital is gone.

- Bank X lends $50 billion to Hedge Fund P with equity of $10 billion, which then buys $60 billion of securities. The value of the fund's portfolio falls to $50 billion; the bank sends a margin call; no additional collateral can be posted; so the bank seizes and sells out the portfolio. But in the downward-spiraling market, the bank only realizes $40 billion. Its capital is gone.

- Hedge Fund Q also borrowed to buy securities. When Hedge Fund P got its margin call and its portfolio was sold out, that forced securities prices downward. So Fund Q – which holds many of the same positions – also receives a margin call, perpetuating the downward spiral and bringing more losses to more institutions.

All of these scenarios, and many others, are connected by a common thread: the combination of leverage and illusory safety, which allowed institutions to take on too much risk for the amount of capital they had.

First, it should be clear from the above that the amount of borrowed money – leverage – that it's prudent to use is purely a function of the riskiness and volatility of the assets it's used to purchase. The more stable the assets, the more leverage it's safe to use. Riskier assets, less leverage. It's that simple.

One of the main reasons for the problem today at financial institutions is that they underestimated the risk inherent in assets such as home mortgages and, as a result, bought too much mortgage-backed paper with too much borrowed money.

Let's go back to the paragraph on page one. Here it is again:

> I'll keep it simple. Suppose you have $1 million in equity capital. You borrow $29 million and buy $30 million of mortgage loans. Twenty percent (or $6 million) of the mortgages go into default, and the recovery on them turns out to be only two-thirds ($4 million). Thus you've lost $2

million . . . your equity capital twice over. Now you have equity capital of minus $1 million, with assets of $28 million and debt of $29 million. Everyone realizes that there'll be nothing left for the people who're last in line to withdraw their money, so there's a run on the bank. And you slide into bankruptcy.

Suppose you set up your leveraged portfolio as described but only 2% of your mortgage holdings go bad, not 20%. Then, you only lose $200,000 (not $2 million) of your $1 million of equity, and you're still solvent. Or suppose 20% of your mortgages default as in the original example, but you only levered up ten times, not 30. You lose the same 6.7% of your assets, but based on $10 million, so it's just $670,000, or two-thirds of your equity. You're still alive. **The problem lies entirely in the fact that the institutions combined highly risky assets with a large amount of leverage.**

By now, everyone recognizes (a) how silly it was for the financial modelers to be so sure there couldn't be a nationwide drop in home prices (they felt that way because there never had been one – but did their data include the Depression?) and (b) the terrible job the agencies did of rating mortgage-related securities. So the risk was underestimated, permitting the leverage to become excessive: end of story. **Reason number one for today's problem, then, is the mismatch institutions turned out to have made between asset risk and leverage.**

The second reason is that, given the degree by which mortgage defaults have exceeded expectations, no one feels like taking a chance on how bad things will get. Everyone agrees it'll be bad, but no one can say how bad.

As I said in October in "The Limits to Negativism," when things are going well, no assumption is too optimistic to be accepted. But when things turn down, none seems too pessimistic. Today, with the ability to lose money on mortgages having been demonstrated so painfully, investors consider themselves unable to say where the losses will stop.

So if a highly leveraged financial institution has significant mortgage holdings, few people are willing to risk money in the belief that the losses will be bearable. If a financial institution has book equity of $100 million and $500 million of mortgage assets, no one will grant that future losses will be less than $100 million – that is, that it'll remain solvent. Maybe the writedowns will be $100 million. Or $300 million. Or $500 million. There's no assumption too negative. As a result, investors will just keep their money in their pockets.

A few sovereign wealth funds and others jumped in a year ago, and based on results so far, it looks like they acted too soon. In July, Goldman Sachs reported that 52 banks had raised capital and the providers of that capital were underwater at 50 of them, by an average of 45%. Certainly things are much worse now.

Most people are behaving as if there's no such thing as investing safely in a financial institution. This widespread belief has the ability to greatly delay the restoration of faith, capital and viability. Peter Bernstein put it succinctly in *The New York Times* of September 28. (Peter's one of the very wisest men around, in part because he's one of the few who can talk about the Depression from experience. I recommend his op-ed piece, "What's Free About Free Enterprise?")

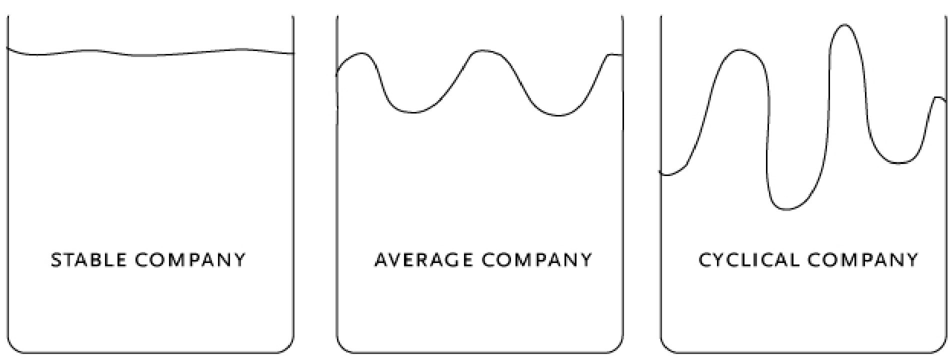
> This time around, assets are evidently so rotten in so many places that no financial institution wants to risk doing business with any other financial institution without a government backstop.

That's the reason why no buyer could be found for Lehman Brothers over the weekend preceding its bankruptcy. No one could assess its assets and get comfortable regarding the status of its highly levered net worth, so everyone required a government backstop . . . which wasn't forthcoming.

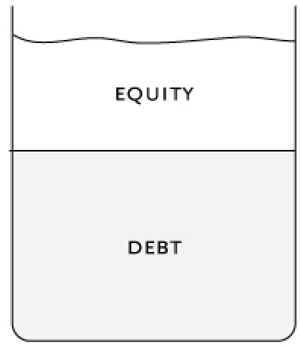
The Right Level of Leverage

Although I communicate primarily in words, I tend to think a lot in pictures – certainly more than in numbers. My concept of appropriate leverage can easily be demonstrated through a few diagrams. I'm going to overlook the differences between accounting value, market value and economic value and confuse the terms. But I think you'll get the idea.

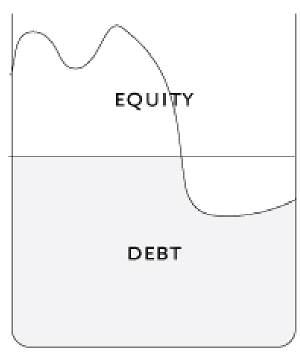
The drawings below show the value of companies of different types. Due to the variability of their earnings, the values fluctuate differently over time.



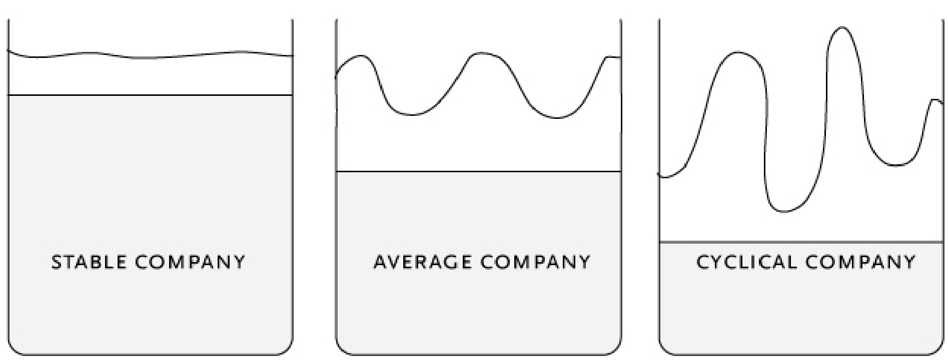
Here's a financial structure, except with the equity above the debt, not below as it would be on a balance sheet:



Now let’s combine the two concepts. The bottom line is that in order for a company to avoid insolvency, its financial structure has to be such that its value won’t fall through the equity and into the debt. In naïve and far-from-technically correct terms, when the amount of debt exceeds the value of the company, it’s insolvent, as suggested below.



What the following doodles illustrate is that for every level of riskiness and volatility, there’s an appropriate limit on leverage in the capital structure.



During the first leveraged buyout boom in the late 1970s and the 1980s, it was a watchword that they should be done only with stable companies. But in bullish times, rules like that are forgotten or ignored, and we get buyouts of companies in cyclical industries like semiconductors or autos.

Extremely leveraged companies have existed for more than a century. They're called utilities. Because their profits are regulated by public commissions and fixed as a percentage of their stable asset bases, they've been extremely dependable. **This shows that high leverage isn't necessarily risky, just the wrong level of leverage given the company's stability.**

It can be safe for life insurance companies to take risk on limited capital, because their operations are steady and their risks can be anticipated. They know everyone will die, and roughly when (on average). But if a firm like MBIA was going to guarantee mortgage securities, it should have recognized their instability and unpredictability and limited its leverage. The insurance industry's way of saying that is that its capital should have been higher as a percentage of the risks assumed. MBIA insured $75 billion of residential and commercial mortgage paper on the basis of total capital – not capital devoted to its insuring mortgage securities, but total capital – of only $3 billion. Did anyone worry about the possibility that 5% of the mortgages would default?

Leverage is always seductive. If you have $1 million of capital and write $25 million of insurance at a 1% annual premium, you bring in $250,000 of premiums, for a 25% return on capital (before losses and expenses). But why not write $50 million of insurance and bring in $500,000? The answer is that policy losses might exceed 2% of the insurance written, in which case your losses would be greater than the capital you have to pay them with . . . and you might be insolvent. **But in order to resist using maximum available leverage, you need discipline and an appreciation for the risks involved. In recent years, few firms had both.**

<ins>Why Mortgages?</ins>

Why is it residential mortgage-related paper that set off the process endangering our institutions? Why not high yield bonds or leveraged loans or even equities? One reason, of course, is the sheer size of the residential mortgage-related securities market: $11 trillion. But there are two others.

The first is the inability to value the underlying collateral. I feel comfortable when Oaktree's analysts value the debt or equity of a cash-flow-producing company. To the extent an asset produces a stream of cash flows, and assuming they're somewhat predictable, the asset can reasonably be valued. But assets that don't produce cash flows can't be valued as readily (this has been a regular theme of mine of late).

What's a barrel of oil worth? $33 in January 2004, $147 in mid-2008, or $42 earlier this month? Which price was "right"? All of them? Or none of them? We all know about the things that will influence the price of oil, such as finite supply, growing demand, and the unreliability of some of the producing nations. But what do those factors make it worth? **No one can convert these intangibles into a fair price.** That's why, a few months ago at $147, we were seeing predictions of $200 oil. And now, with the price down two-thirds, there's talk of $25.

The same is true of commodities, gold, currencies, art and diamonds. And houses. **What's a house worth? What it cost to build? What it would cost to replace today? What it last sold for? What the one next door sold for? The amount that was borrowed against it? (Certainly not.) Some multiple of what it could be rented for? What about when there are no renters? The answer is "none of these." On a given day, houses – and all of the things listed just above – are worth only what someone will pay for them.** Well, that's true in the short run for corporate securities, too, as we've seen in the last few months. But in the long run, you can expect security prices to gravitate toward the discounted present value of their future cash flows. There's no such lodestone for houses.

Think about one of the biggest jokes, the home appraisal. If a house doesn't have a "value," what do mortgage appraisers do? They research recent sales of similar houses nearby and apply those values on a per-square-foot basis. But such an appraisal obviously says nothing about what a house will bring after being repossessed a few years later.

Nevertheless, in recent years, a purchase price of $X, supported by an appraisal of $X, was used to justify lending 95% of $X – or maybe 100% or 105% – when a home was bought or refinanced. No wonder homes valued in the biggest boom in history have turned out to be unreliable collateral.

Second, these overrated mortgages were packaged into the most alchemical and fantastic leveraged structures. It is these, not mortgages themselves, that have jeopardized our institutions. There was a limited market for whole mortgage loans; they were considered a specialist market entailing risk and requiring expertise. But supposedly those worries would be obviated if one bought the debt of structured entities that invested in residential mortgage-backed securities (RMBS).

First question: where did the risk go? We were told it disappeared thanks to the magic of structuring, tranching and diversifying, permitting vast amounts of leverage to be applied safely. Second question: how reliable was the diversification? Answer: again we were told, highly reliable; there had never been a national decline in home prices, so mortgages could be considered uncorrelated with each other. The performance of a mortgage on a house in Detroit would be unaffected by what went on in Florida or California. (Well, so much for what we were told.)

The institutions' writedowns generally are in collateralized debt obligations (CDOs), debt issued by special-purpose entities that borrowed huge amounts relative to their equity in order to purchase mortgage-related securities. As described earlier, underestimated risk led to the use of unwise amounts of leverage. But interestingly, the key losses aren't in the riskier junior tranches of CDO debt, about which there was some leeriness. Rather, they're in the triple-A-rated tranches. It's to buy those tranches that our leading institutions took on too much leverage. **Once again, greatly underestimated risk led to great leverage and thus great losses.**

What did you need to steer clear of CDO debt? Computers, sophisticated programs and exceptional analysis? Genius? No: skepticism and common sense. In RMBS, CDOs and CDO-squareds (entities that borrowed to buy CDO debt), **90% or so of their capital structure was rated higher than the underlying collateral, all based on the linchpin assumption that mortgages were uncorrelated. That's all you had to know.**

How good a piece of collateral is a subprime mortgage covering 100% of the purchase price of a house bought in a soaring market by an applicant who'll pay a higher interest rate to be able to skip documenting income or employment? That's not a secured loan; it's an option on future appreciation. If the house goes up in price, the buyer makes the mortgage payments and continues to own it. If it goes down, the buyer walks away, in which case the lender gains ownership of a house worth less than the amount loaned against it. Thus the viability of the mortgages was entirely dependent on continued home price appreciation.

Given the above, what was the credit quality of subprime mortgages? I'd say double-B at best. (I'd much rather buy even the single-B "junk bonds" of profitable companies that we've held over the last 30 years than this inflated "home option" paper.) And yet, in a typical CDO, 80% of the debt was rated triple-A and 97% was rated investment grade (triple-B or better). Those high ratings made CDO debt very attractive to financial institutions that were able to borrow cheaply to buy high-rated assets, satisfying the strict rules regarding the "quality" of their portfolio holdings.

Financial engineers and investment bankers took unreliable collateral and packaged it into highly leveraged structures supporting debt that was rated high enough to attract financial institutions. What a superb example of the imprudent use of leverage. And what a simple explanation of how our highly leveraged institutions got into trouble.

<u>How Bad is Bad?</u>

One of the prime lessons that must be learned from this experience is that in determining how much leverage to put on, you'd better make generous assumptions about how risky your assets might turn out to be.

The example in the paragraph on page one demonstrates the role of risk in the equation. The more your assets are prone to permanent loss, the less leverage you should employ. But it's also important to recognize the role of volatility. Even if losses aren't permanent, a downward fluctuation can bring risk of ruin if a portfolio is highly leveraged and (a) the lenders can cut off credit, (b) investors can be frightened into withdrawing their equity, or (c) the violation of regulatory or contractual standards can trigger forced selling.

The problem is that extreme volatility and loss surface only infrequently. And as time passes without that happening, it appears more and more likely that it'll never happen – that assumptions regarding risk were too conservative. Thus it becomes tempting to relax rules and increase leverage. And often this is done just before the risk finally rears its head. As Nassim Nicholas Taleb wrote in *Fooled by Randomness*:

> Reality is far more vicious than Russian roulette. First, it delivers the fatal bullet rather infrequently, like a revolver that would have hundreds, even thousands of chambers instead of six. After a few dozen tries, one forgets about the existence of a bullet, under a numbing false sense of security . . . Second, unlike a well-defined precise game like Russian roulette, where the risks are visible to anyone capable of multiplying and dividing by six, one does not observe the barrel of reality. . . . **One is thus capable of unwittingly playing Russian roulette – and calling it by some alternative "low risk" name.** (p. 28; emphasis added)

The financial institutions played a high-risk game thinking it was a low-risk game, all because their assumptions on losses and volatility were too low. We'd be watching an entirely different picture if only they'd said, "This stuff is potentially risky. Since home prices have gone up so much and mortgages have been available so easily, there just might be widespread declines in home prices this time. So we're only going to lever up half as much as past performance might suggest."

It's easy to say they should have made more conservative assumptions. But how conservative? **You can't run a business on the basis of worst-case assumptions. You wouldn't be able to do anything.** And anyway, a "worst-case assumption" is really a misnomer; there's no such thing, short of a total loss. Now we know the quants shouldn't have assumed there couldn't be a nationwide decline in home prices. But once you grant that such a decline can happen – for the first time – what extent should you prepare for? Two percent? Ten? Fifty?

One of my favorite adages concerns the six-foot-tall man who drowned crossing the stream that was five feet deep on average. It's not enough to survive in the investment world on average; you have to survive every moment. The unusual turbulence of the last two years – and especially the last three months – made it possible for that six-foot-tall man to drown in a stream that was two feet deep on average. <u>**Should the possibility of today's events have been anticipated? It's hard to say it should have been. And yet, it's incumbent upon investors to prepare for adversity. The juxtaposition of these sentences introduces an interesting conundrum.**</u>

Consider these tales from the front lines:

- There had never been a national decline in home prices, but now the Case-Shiller index is down 26% from its peak in July 2006, according to the *Financial Times* of November 29.

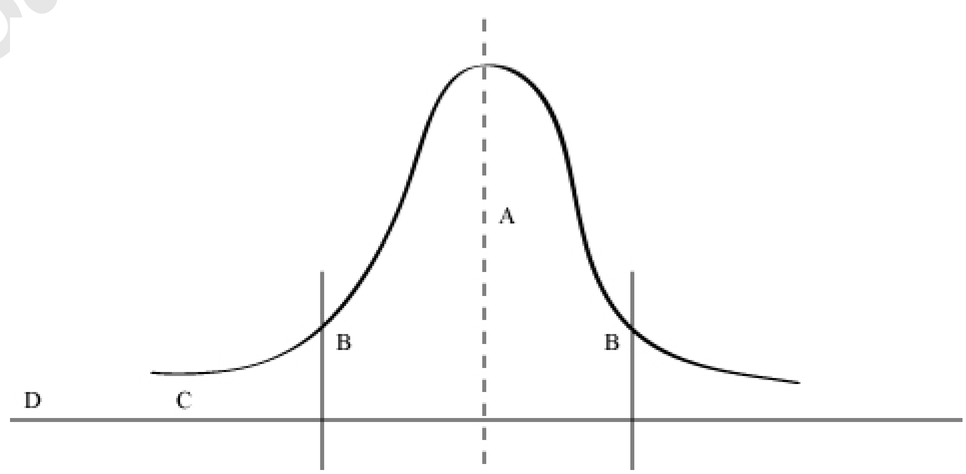
- In my twenty-nine previous years with high yield bonds, including four when more than 10% of all outstanding bonds defaulted, the index's worst yearly decline was 7%. But in 2008, it's down 30% (even though the last-twelve-months' default rate is only about 3%).

- Performing bank loans never traded much below par in the past, and holders received very substantial recoveries on any that defaulted. Now, even though there have been few defaults, the price of the average loan is in the 60s.

The headlines are full of entities that have seen massive losses, and perhaps meltdowns, because they bought assets using leverage. Going back to the diagrams on pages 4-5, these investors put on leverage that might have been appropriate with moderate-volatility assets and ran into the greatest volatility ever seen. **It's easy to say they made a mistake. But is it reasonable to expect them to have girded for unique events?**

If every portfolio was required to be able to withstand declines on the scale we've witnessed this year, it's possible no leverage would ever be used. Is that a reasonable reaction? (In fact, it's possible that no one would ever invest in these asset classes, even on an unlevered basis.)

In all aspects of our lives, we base our decisions on what we think probably will happen. And, in turn, we base that to a great extent on what usually happened in the past. We expect results to be close to the norm (A) most of the time, but we know it's not unusual to see outcomes that are better or worse (B). Although we should bear in mind that, once in a while, a result will be outside the usual range (C), we tend to forget about the potential for outliers. And importantly, as illustrated by recent events, we rarely consider outcomes that have happened only once a century . . . or never (D).



Even if we realize that unusual, unlikely things can happen, in order to act we make reasoned decisions and knowingly accept that risk when well paid to do so. Once in a while, a "black swan" will materialize. But if in the future we always said, "We can't do such-and-such, because we could see a repeat of 2007-08," we'd be frozen in inaction.

So in most things, you can't prepare for the worst case. It should suffice to be prepared for once-in-a-generation events. But a generation isn't forever, and there will be times when that standard is exceeded. What do you do about that? **I've mused in the past about how much one should devote to preparing for the unlikely disaster. Among other things, the events of 2007-08 prove there's no easy answer.**

Are You Tall Enough to Use Leverage?

Clearly it's difficult to always use the right amount of leverage, because it's difficult to be sure you're allowing sufficiently for risk. Leverage should only be used on the basis of demonstrably cautious assumptions. And it should be noted that **if you're doing something novel, unproven, risky, volatile or potentially life-threatening, you shouldn't seek to maximize returns. Instead, err on the side of caution. The key to survival lies in what Warren Buffett constantly harps on: margin of safety.** Using 100% of the leverage one's assets might justify is often incompatible with assuring survival when adverse outcomes materialize.

Leverage is neither good nor bad in and of itself. In the right amount, applied to the right assets, it's good. When used to excess given the underlying assets, it's bad. It doesn't add value; it merely magnifies both good and bad outcomes. So leverage shouldn't be treated as a silver bullet or magic solution. It's a tool that can be used wisely or unwisely.

Our attitude at Oaktree is that it can be wise to use leverage to take advantage of high offered returns and excessive risk premiums, but it's unwise to use it to try to turn low offered returns into high ones, as was done often in 2003-07.

Once leverage is combined with risky or volatile assets, it can lead to unbearable losses. Thus leverage should be used in prudent amounts, to finance the right assets, and with a great deal of respect. And it's better used in the trough of the cycle than after a long run of appreciation. **Bottom line: handle with care.**

* * *

I never want to give the impression that doing the things I discuss is easy, or that Oaktree always gets it right. This memo calls on investors to gauge risk and use only appropriate leverage. At Oaktree we assess fundamental riskiness and look to history for how markets might behave, and we heavily emphasize trying to build in sufficient room for error. But history isn't a perfect guide. While we've made no use of leverage in the vast majority of our investment activities, three of our evergreen funds did borrow to buy bank loans: the senior-most debt of companies, which in the past always has traded around par. Another used it to buy low-priced Japanese small-cap stocks. The companies generally are doing fine, but the prices of their loans and equities have collapsed under current market conditions, causing the funds to suffer. **This shows how tough it is to prepare for all eventualities . . . in other words, to know in advance how bad is bad**. So I apologize if I ever come across as holier-than-thou. We've tried to use leverage only when it's wise, but no one's perfect. Certainly not us.

*   *   *

The financial markets have delivered a lifetime of lessons in just the last five years. Some of the most important ones center around the use and abuse of leverage.

- **Leverage doesn't add value or make an investment better.** Like everything else in the investment world other than pure skill, leverage is a two-edged sword – in fact, probably the ultimate two-edged sword. It helps when you're right and hurts when you're wrong.

- **The riskier the underlying assets, the less leverage should be used to buy them.** Conservative assumptions on this subject will keep you from maximizing gains but possibly save your financial life in bad times.

- A levered entity can be caught up in a downward spiral of asset price declines, market-value tests, margin calls and forced selling. Thus, in addition to thinking about the right amount of leverage, it's important to note that there are two different kinds: permanent leverage, with its magnifying effect, and leverage which can be withdrawn, which can introduce collateral tests and the risk of ruin. Both should be considered independently. **Leverage achieved with secure capital isn't nearly as risky as situations where you are subject to margin calls or can't bar the door against capital withdrawals.**

Leverage was too easily accessed as recently as two years ago, and now it's virtually unavailable. And just as its use was often unwise a few years ago, this might be just the right time to employ some if you can get it . . . and if you can arrange things so you won't drown if the streambed dips ahead.

December 17, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Long View

Many of my memos over the last year and a half have touched on the developments in 2003-07 that brought on the current financial crisis. By now, everyone understands the role of innovation, risk tolerance and leverage in the boom that led to the bust, so I think it's now time to look back considerably further.

<u>The Importance of Cycles</u>

In my opinion, there are two key concepts that investors must master: value and cycles. For each asset you're considering, you must have a strongly held view of its intrinsic value. When its price is below that value, it's generally a buy. When its price is higher, it's a sell. In a nutshell, that's value investing.

But values aren't fixed; they move in response to changes in the economic environment. Thus, cyclical considerations influence an asset's current value. Value depends on earnings, for example, and earnings are shaped by the economic cycle and the price being charged for liquidity.

Further, security prices are greatly affected by investor behavior; thus we can be aided in investing safely by understanding where we stand in terms of the market cycle. What's going on in terms of investor psychology, and how does it tell us to act in the short run? We want to buy when prices seem attractive. But if investors are giddy and optimism is rampant, we have to consider whether a better buying opportunity mightn't come along later.

<u>The Lessons – and Limits – of Experience</u>

I feel good about having been aware of where we stood in terms of the market cycle and investor behavior over the last four or five years. There were memos that talked about low prospective returns and meager risk premiums ("Risk and Return Today," October 2004), repetition of past mistakes ("There They Go Again," May 2005), investor inattention to warning signs ("Hindsight First, Please," October 2005), and the rising willingness to accept lower returns and less safety ("The Race to the Bottom," February 2007). Importantly, these views were factored into Oaktree's actions, enabling us to make some good decisions on behalf of our clients.

I recite these successes not for the purpose of self-congratulation, but to point out that while I was highly aware of the short-term cycle, I – like almost everyone else, it seems – failed to fully appreciate the big-picture peril implied by the level to which the cycle had risen. In short, I thought 2003-07 was like the other cycles I've lived through, just more so. I missed the fact that it was different not only in degree, but also in kind.

This episode is different because over the preceding decades, the accretion of progressively higher highs and higher lows – in a large number of phenomena – brought us to a macro-high that hadn't been witnessed for many years and held great danger . . . as we're seeing.

Forty years have passed since I first served as a summer trainee in First National City Bank's Investment Research Department. My experience in seeing investors punished in 1969-70, 1973-74, 1977, 1981, 1987, 1990, 1994 and 2000-02 is what enabled me to detect the excesses of 2003-07. But since I didn't live through the Great Depression or work through the full run-up to the painful 1970s, I didn't have the perspective needed to understand where those relatively short cycles of boom/bust/recovery were taking us.

Long-Term Trends

Looking back over my career, it's clear that the securities markets have been riding a number of salutary secular trends ("secular," as in "of or relating to a long term of indefinite duration" per *Webster's New Collegiate Dictionary*). Some of these actually began at the end of World War II and ran through 2007, for a total of more than six decades.

Macro Environment – The period following World War II was one of American dominance and prosperity. The U.S. benefited from the "baby boom," the fact that our shores hadn't been reached by the war, and the effective transition of our factories and labor force to peacetime use. We were aided by a modern infrastructure, strong education and healthcare systems, and gains in technology.

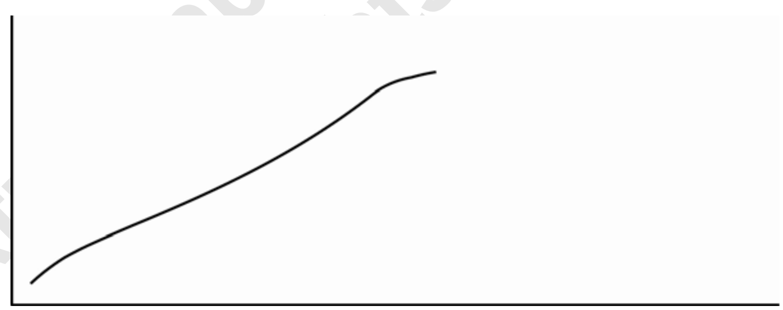
Corporate Growth – The last sixty years have seen strong growth in corporations and their profits. Especially in the early part of this period, the U.S. developed superior products, produced them very efficiently and found ready markets in the rest of the world. Gains in automation, information technology, management practices and productivity all contributed. Growth in sales was supported by strong consumer demand.

The Borrowing Mentality – As further discussed below, advances in financing – and greater acceptance of the use of debt – allowed companies to augment their growth rates and returns on capital and allowed consumers to increase consumption. In fact, over the last several decades, economic units of all sorts in the U.S. increased their use of debt. Consumers, businesses, governments and investors all wanted to borrow more, and the financial services industry developed products to accommodate them. Spending and investment was facilitated through the extension of credit at all levels, contributing to economic expansion but also sowing the seeds for the current situation.

Popularization of Investing – Back in 1968, working in investment management was no different from entering banking or insurance. Investing wasn't the high-profile area it's been the last two decades. "Famous investor" was an oxymoron; none were household names, like Warren Buffett, George Soros and Peter Lynch would become. Investment firms weren't the B-school employer of choice, and investment managers didn't dominate magazine covers and the top income brackets. But over the last forty years, increased attention was paid to equities, mutual funds, hedge funds and alternative niche markets. Even homes came to be viewed as investment vehicles.

Investor Psychology – Attitudes morphed over time. Instead of a generation scarred by the Great Depression, people became increasingly confident, optimistic and venturesome. Experience convinced prospective investors that stocks could be counted on for high returns. In the last few decades, there've been times when people concluded the business cycle had been tamed. During Alan Greenspan's reign, people came to believe inordinately in his ability to keep the economy growing steadily. And most recently, people swallowed the canard that innovation, financial engineering and risk modeling could take the uncertainty out of investing.

The developments enumerated above constituted a strong tailwind behind the economy and the markets over the last several decades, and they produced a long-term secular uptrend.



<u>Short-Term Cycles</u>

Despite the underlying uptrend, there's been no straight line. The economy and markets were punctuated every few years by cyclical bouts of short-term fluctuation. Cycles around the trend line made for frequent ups and downs. Most were relatively small and brief, but in the 1970s, economic stagnation set in, inflation reached 16%, the average stock lost almost half its value in two years, and *Business Week* magazine ran a cover story trumpeting "The Death of Equities." No, my forty years haven't been all wine and roses.

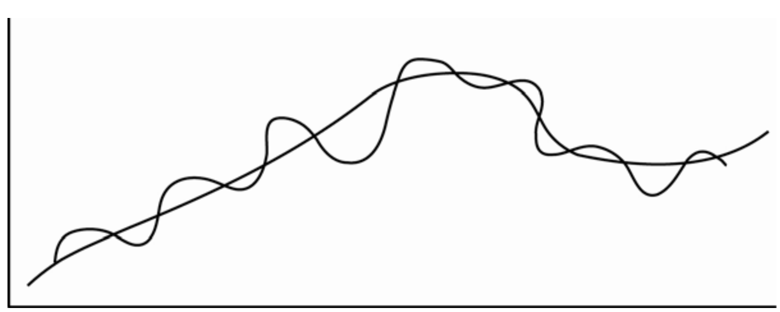
From time to time we saw better economies and worse – slowdown and prosperity, recession and recovery. Markets, too, rose and fell. These fluctuations were attributable to normal economic cycles and to exogenous developments (such as the oil embargo in 1973 and the emerging market crisis in 1998). The S&P 500 had a few down years in the period from 1975 to 1999, but none in which it lost more than 7.5%. On the upside, however, 16 of those 25 years showed returns above 15%, and seven times the annual gain exceeded 30%.

Despite the ups and downs, investors profited overall, investing became a national pursuit, and America's richest man got that way by buying common stocks and whole companies. A serious general uptrend was underway, reaching its zenith in 2007.

<u>The Rest of the Elephant</u>

There's an old story about a group of blind men walking down the road in India who come upon an elephant. Each one touches a different part of the elephant – the trunk, the leg, the tail or the ear – and comes up with a different explanation of what he'd encountered – a tree, a reed, a palm leaf – based on the small part to which he was exposed. **We are those blind men. Even if we have a good understanding of the events we witness, we don't easily gain the overall view needed to put them together. Up to the time we see the whole in action, our knowledge is limited to the parts we've touched.**

Until mid-2007, my experience as a money manager had been limited to part of the long-term story. Perhaps **what looked like an underlying long-term uptrend should have been viewed instead as the positive part of a long-term cycle incorporating downs as well as ups.** Only when you step back from the beast can you gauge its full proportions.



<u>Cycles in Long-Term Trends</u>

The main thing I want to discuss in this memo is my realization that there are cycles in the long-term trend, not just short-term cycles around it, and we've been living through the positive phase of a big one.

Over the last few decades, investors have reacted to the generally positive economic environment by taking actions reflecting increased optimism and trust, as well as reduced caution and conservatism. **In hindsight, we can see nearly uninterrupted growth in behavior that (a) relied on a continuation of the favorable underlying trends and thus (b) can be described as increasingly bullish.**

Looking for just one word, I'd say there was a steady rise in "willingness." Over my forty years in business – but probably carrying on from the end of the World War II – I believe investors grew increasingly willing . . .

- to forget old-fashioned concepts like "saving for a rainy day," fiduciary responsibility and preservation of capital,
- to pursue capital appreciation rather than settle for more modest, steady income,
- to invest on the basis of growth potential rather than existing value,
- to trust that stocks would provide superior performance (see separate section below),
- to drastically reduce the representation of high grade bonds in portfolios,
- to move away from stocks and bonds and toward more exotic investments,
- to believe that diversification into risky assets would increase return more than risk,
- to pursue profit through proprietary investing if you were a bank or investment bank, and for endowments to try to be "more like Yale,"
- to assume that markets would function smoothly even in tough times,
- to trust in markets to solve all problems, induce constructive behavior and efficiently allocate capital, allowing regulation to be reduced,
- to accept that, thanks to market efficiency, asset prices are always "right,"
- to trust in the Fed, Alan Greenspan and the ability to restrain cycles,
- to rely on quants and financial engineers, spreadsheets and risk modeling,
- to feel confident they had a good handle on what the future held,
- to believe in alpha, absolute return, widespread genius among money managers, free lunches, and superior asset classes regardless of how they're priced,
- to revere and trust money managers sporting good returns,
- to share investment gains with money managers, perhaps in ways that motivated them to take increased risk in pursuit of short-term profits,
- to view houses, art, jewelry and collectibles as financial assets,
- to believe that real estate prices couldn't go down,
- to treat investing as a national pastime via TV, magazines and books,
- to "buy the dips,"
- **to accept new paradigms,**
- **to relax diligence standards and forget to question skeptically,**

- **to use past statistical averages – sometimes covering brief time periods – to gauge the safety of prospective investments,**
- **to partake in financial innovation and invest in things too complex or opaque to be understood,**
- **to believe that risk had been banished, most recently through securitization, tranching and decoupling,**
- **to forgo liquidity,**
- **to make increasing use of leverage (see separate section below),**
- **to finance investment activities with undependable capital: short-term borrowings and deposits, impermanent equity, and future cash receipts,**
- **to forget to worry and be risk-averse, and thus**
- **to accept additional risk at shrinking risk premiums.**

The "era of increasing willingness" carried many trends to higher highs. The last ten listed above were the prime ingredients giving rise to the current crisis. Together they produced an investment house of cards that was enormously dependent on continued prosperity, bullishness and easy money.

Expansiveness

In addition to "willingness," one of the most significant trends during the period under discussion has been a massive increase in "expansiveness," my new label for the desire to increase the ratio of activity to capital. If that sounds unfamiliar, the common term in America is "leverage," and in England it's "gearing."

My last memo was on the subject of leverage and its major role in the crisis we're all experiencing. Today's problems are largely a function of the high levels of leverage employed in 2003-07, but those levels were just the apogee of a progression that spanned decades.

Every business, government, non-profit organization or individual has a certain amount of equity capital, net worth or surplus. That capital, in turn, will support a certain level of activity: production and sales, lending, government action, charitable grants or consumption. **But over the last several decades, if you wanted to do more of these things than your capital permitted, you could borrow capital from someone else.**

Over the course of my lifetime, there have been extraordinary changes in the extent of borrowing:

- **Consumers –** When I went off to college 45 years ago, I paid for purchases with checks or cash, and I saved up coins for the payphone. "Travel and entertainment" cards like American Express and Diners Club were available only to those with top credit ratings, and the masses lived without credit cards until Citibank introduced The Everything Card (now MasterCard) around 1967. In the old days, consumers who lived beyond their incomes were often described as being "in debt." We don't hear that term anymore, since people with unpaid credit card balances and consumer loans are the rule, not the exception. As a result, consumer credit outstanding grew 260 times from 1947 to 2008, increasing from 4.2% of gross domestic product to 17.9%. (Federal Reserve data and Economagic)

- **Homeowners –** In the old days, homebuyers, having saved for years, usually put down 20% of the cost of a home and borrowed the rest through a thirty-year fixed-rate mortgage. They made payments until that debt was eliminated, and they held mortgage-burning parties to celebrate the event, which would enable them to retire mortgage-free. Only people who were "in trouble" took out second mortgages, perhaps to meet emergency expenses. All of these concepts went out the window in recent times, when down payments, fixed rates and paid-off mortgages became things of the past, replaced by 100% financing, adjustable rates, teasers and serial refinancings. Second mortgages were relabeled "home equity loans," little miracles that would let people draw out the inevitable appreciation in their homes, spend it, and end up with the same home and larger payments – perhaps just as interest rates moved up or as the borrowers hoped to be able to retire.

- **Corporations –** "In the beginning," corporate borrowing was most undemocratic. Prior to the late 1970s, only firms with investment-grade credit ratings of triple-B or better could publicly issue bonds. But that changed with the introduction of high yield bonds, an innovation permitting low-rated issuers to borrow at high interest rates. Before the advent of high yield bonds, companies could be acquired only by companies bigger than themselves. But with high yield bonds, small firms and even wealthy individuals could borrow enough to acquire corporate giants. This created the leveraged buyout industry. In recent years, not only was debt added to capital structures (particularly through buyouts), but equity was subtracted. Buyout companies used borrowed funds to dividend out their owners' equity and provide quick profits, and non-buyout companies bought back their shares, often using borrowed money. These activities substituted debt for equity in companies' capital structures, levering up their results and reducing their margin for error. In the current credit crisis, this has led to large-scale capital destruction.

- **Financial Institutions –** Over the decades in question, banks and investment banks moved away from working for interest, fees and commissions as lenders, advisers, brokers and agents. Instead, they went increasingly into positioning (buying or selling blocks of stock to accommodate clients when the market wouldn't take that side of a trade), proprietary trading (making investments for their own accounts, not on behalf of clients), and creating derivatives (sometimes ending up with a holding), all on the basis of increased leverage. "In 1980, bank indebtedness was equivalent to 21 percent of U.S. gross domestic product. In 2007 the figure was 116 percent. . . . It was not unusual for investment banks' balance sheets to be as much as 20 or 30 times larger than their capital, thanks in large part to a 2004 rule change by the Securities and Exchange Commission that exempted the five largest of those banks from the regulation that had capped their debt-to-capital ratio at 12 to 1." (*Vanity Fair*, December 2008)

- **Governments –** Similarly, governments at all levels learned increasingly to spend borrowed money in addition to their revenues. Federal, state and local debt ballooned to facilitate both capital projects (reasonably) and deficit spending (less reasonably). The Federal debt grew from $1 trillion in 1980 to $11 trillion today. How? In 2003 and 2004, for example, the government spent $1.42 per $1 of income taxes. In this way, the U.S. became a debtor nation, dependent on bond buyers – particularly from abroad – to let it spend beyond its means. Likewise, state and local debt grew from $1.19 trillion in 2000 to $1.85 trillion in 2005, an average increase of 9.2% per year. In an extreme example of unwise innovation, much of the issuance of muni bonds was made possible because weak issuers could obtain bond insurance; few prospective investors, however, looked into the financial strength of the insurers.

- **Investors in General –** Fifty years ago, the main way investors expanded their activities was through the use of "margin," borrowing from their brokers to buy stock. Initial margin for new purchases was strictly limited to 100% (e.g., at most you could buy $2 worth of stock for every $1 of equity in your account). But Wall Street proved increasingly creative, and in the current decade it came up with products "with the leverage inside." These made much more than 100% leverage available to investors without any explicit borrowing. Hedge and arbitrage funds, collateralized loan obligations, collateralized debt obligations, leveraged buyout funds, credit default swaps and other derivatives; all of these delivered participation in highly leveraged investments without requiring the end investor to use margin or take out loans. In what approached a joke, the prim limit on margin was maintained even as regulators declined to apply any limits or regulation to these other investment structures, despite their ability to provide almost infinite leverage.

- **Institutional Investors –** Given their tax-exempt status, pension funds and charitable and educational endowments can't borrow to increase their returns. But they can (and did) make use of some of the strategies listed above. Institutional investors also employed "portable alpha," overlaying hedge fund investments with index futures to simulate more-than-100%-invested positions, and they overcommitted to private equity partnerships to ensure their capital would be fully deployed.

The use of borrowed money expanded at all levels over the last few decades. This occurred largely without changes in laws or institutions. Instead, the changes were in customs and attitudes, abetted by financial institutions' innovation of new products.

<u>Of all the investment adages I use, this one remains the most important: "What the wise man does in the beginning, the fool does in the end</u>." Practices and innovations often move from exotic to mainstream to overdone, especially if they're initially successful. What early investors did safely, the latecomers tried in 2003-07 with excessive leverage applied to overpriced and often inappropriate assets. As I wrote in "It's All Good" (July 2007), leverage was the "ketchup" of this period, used to make unattractive underlying investments appear tasty. The results have been disastrous.

Here's another way to put it, from *The Wall Street Journal* of November 24,

> When it comes to booms gone bust, "over-investment and over-speculation are often important; but they would have far less serious results were they not conducted with borrowed money."

That statement wasn't made in reference to current events; that was Irving Fisher writing 76 years ago ("The Debt-Inflation Theory of Great Depressions," *Econometrica*, March 1933). Borrowed money lets economic units expand the scale of their activity. But it doesn't add value or make things better; it just makes gains bigger and losses more painful. There's an old saying in Las Vegas: "The more you bet, the more you win when you win." But they always forget to add ". . . and the more you lose when you lose."

In one of those beautiful phrasings that demonstrate his mastery of language, Jim Grant of *Grant's Interest Rate Observer* has described liquidity and leverage as **"money of the mind."** By this he means they're intangible and ephemeral, not dependable like assets or equity capital. Someone may lend you money one day but refuse to renew your loan when it comes due. Thus, **leverage is purely a function of the lender's mood.** The free-and-easy lending of 2003-07 has turned into an extreme credit crunch, and the unavailability of credit is both the root and the hallmark of today's biggest problems. **Those who expand the scope of their operations on the basis of borrowed money should always consider the possibility that lenders will change their mind.**

Use of Debt in the Corporate World

Note three things regarding debt. **First, all businesses borrow**. Debt is used broadly to finance things ranging from inventories to capital investment. If companies had to wait to get paid by buyers before ordering new goods to sell, business would go much slower. And if all their capital had to be equity, capital would be much more costly and companies would be much smaller. Borrowing makes the business world go 'round.

Second, debt is rarely repaid. Businesses rarely reduce their total indebtedness. Rather than being paid off, debt is simply rolled over. That makes the solvency of the borrowers contingent on the continuous availability of credit.

Third, given that the yield curve normally slopes upward, short-term borrowing is almost always the least expensive. That's what led First National City Bank to invent commercial paper in the 1960s, enabling companies to borrow at short-term rates through short-dated paper that would be renewed every month or so. The upward slope of the yield curve encourages people to borrow short even when investing long, resulting in economic maximization when they're able to roll over their debts but disaster when they aren't. (The recent failure of "auction-rate preferreds" was a good example of the folly of trying to game the yield curve by financing for the long term at short-term rates.)

Here's what follows from the above:

- Most companies have debt, not just those that have made acquisitions or built plants. Companies borrow in the normal course of business.
- Many companies have heavy short-term borrowings and thus the need to deal with substantial maturities in the period immediately ahead.
- With the capital markets closed, not only will growth be difficult to finance, but significant defaults may also arise due to a widespread inability to refinance.

While I always hesitate to predict the future, I think there's a good chance the next year or so will be characterized by significant difficulty repaying and refinancing borrowings. It's worth noting in that context that "In November, there wasn't one sub-investment grade corporate bond issued, according to Reuters – the first such hiatus since March 1991." (*breakingviews.com*, December 3)

<u>Attitudes Regarding Equities</u>

One of the biggest changes in the past century – fully visible only to those who already were adults several decades ago or who've read about it – took place in terms of attitudes towards equities (or what we used to call common stocks).

Up until the middle of the last century, stocks were considered highly speculative, and bonds were the bedrock of most investment portfolios. Interestingly in that connection, it was reported recently that the S&P 500 now out-yields the 10-year Treasury for the first time in 50 years. **Until the 1950s, equities always provided higher current yields . . . for the simple reason that they had to. People invested primarily for yield, and riskier securities – stocks – would attract buyers only if they promised higher yields than bonds.**

This changed in the second half of the 20th century:

- Common stock investing was popularized; I believe Charlie Merrill of Merrill Lynch deserves a lot of the credit for this.
- Prior to some pioneering computer work at the University of Chicago in the 1960s, the historic returns on stocks had never been scientifically quantified. Then the Center for Research in Security Prices came up with the 9.2% compound annual return that fired many investors' appetites.
- The concept of growth-stock investing was popularized in the 1960s; I remember reading a broker's brochure about companies with exciting earnings growth. This led to the "nifty-fifty" investing craze, in which investors (and especially bank trust departments) bought the stocks of fast-growing companies regardless of valuation.

The equity boom burst in the 1970s. We experienced an oil embargo, a very serious recession, inflation rates ranging up to 16%, a 45% decline in the S&P 500 in 1973-74, and considerably larger losses in nifty-fifty stocks. The stock market stayed in the doldrums for years, brokers drove cabs (literally), and *Business Week* ended a dismal decade with its downbeat cover story on stocks.

In fact, the economy, markets and attitudes turned so negative for so long in the 1970s that rather than a ***downward cycle around* the long-term upward trend,** one might say the decade marked a ***downturn in* the long-term trend** (clearly there's no standard for these things). Regardless of what you call it, the decline was so big that it took almost eleven years for the Dow Jones Industrials to get back to the high it reached at the beginning of 1973.

But in 1982, stocks returned to what would be a 25-year bull market, and there arose an even greater cult of equities. Wharton Professor Jeremy Siegel wrote *Stocks for the Long Run,* showing there'd never been a long period in which stocks hadn't outperformed cash, bonds and inflation. Everyone concluded stocks were the asset class of choice and the ideal investment. "65/35" was the usual stock/bond balance in institutional portfolios, but eventually stocks became more heavily weighted, as strong performance in the 1980s and '90s further fired peoples' ardor and as stocks' long-term return was upgraded to 11%. **Few investors recognized that increasing past returns bode poorly – not well – for subsequent returns, or that common stock returns couldn't forever outpace the rate of growth in corporate profits.** In 1999, James Glassman chimed in with his book *Dow 36,000,* asserting that because stocks were such solid investments, equity risk premiums were higher than they should have been, meaning their prices were too low. That pretty much marked the long-cycle top.

When the "tech-media-telecom" bubble burst in 2000, stocks went into their first three-year decline in almost 70 years. The broad indices stabilized after 2002 and returned to their 1999 highs in 2007 but, wanting more than equities' unlevered return, investors shifted their focus to private equity and to equity hedge funds. All of this occurred just in time for the onset of the credit crisis. Last year's 38.5% decline in the S&P 500 was the biggest since 1931, zeroing out more than a decade of gains.

I wonder whether and to what extent equities will be returned to the pedestal of popularity. *The Wall Street Journal* put it aptly on December 22:

> One of the hallmarks of the long market downturns in the 1930s and the 1970s has returned: Rank-and-file investors are losing faith in stocks.
>
> In the grinding bear markets of the past, huge stock losses left individual investors feeling burned. Failures of once-trusted firms and institutions further sapped their confidence. Many disenchanted investors stayed away from the stock market, holding back gains for a decade or more.
>
> Today's investors, too, are surveying a stock-market collapse and a wave of Wall Street failures and scandals. Many have headed for the exits:

> Investors pulled a record $72 billion from stock funds overall in October alone . . . .
>
> If history is any guide, they may not return quickly.

I want to make a heretical assertion: that equities aren't the greatest thing since sliced bread, but rather an asset class that can do well or poorly depending on how it's priced. Investors fell into a trap at the 1999 peak because they were seduced by stocks' long-term average return in addition to their recent gains. Rather than ask "What's been the historic return on stocks?" they should have asked "What's been the historic return on stocks if you bought them when the average p/e ratio was 29 (which it was at the time)?" Once again, investors came to believe in the magic asset class and forgot the importance of reasonable valuation.

The truth is, rather than being superior, equities are an inferior asset class . . . structurally, that is. Unlike debt, they don't promise annual interest or repayment at maturity, and they don't carry a senior claim against the company's assets in case of trouble. All they offer is an uncapped participation in profits. Debt promises a stream of contractual payments, and common stocks provide the residual that remains after those payments have been made. **Thus equities' higher historic average and potential future returns should be viewed as nothing more than compensation for their inferior status and greater volatility. They're not magic, just securities that can perform well when they're priced right for the coming profits. If sluggish growth lies ahead for the economy in the next few years, it's no given that common stocks will outperform corporate bonds.**

<u>Go Around, Come Around</u>

Mark Twain is alleged to have said "History doesn't repeat itself, but it does rhyme." Mistakes follow long-standing patterns, but applied in new ways. Thus it's worth noting a few of the many ways in which events of the pre-crisis years are reminiscent of the Roaring Twenties that preceded the Great Crash.

- In the 1920s, stock manipulators banded together to force down the price of stocks through non-stop short selling. The damage caused by these "bear raids" led to implementation of the "uptick rule," under which shares could be shorted only at prices higher than the last. This rule made it hard for short sellers to drive down prices, and it remained in effect right up until July 2007. Its elimination enabled bears to once again drive down the stocks of weakened financial institutions, an emblematic event in 2008.

- The combination of banking and investment banking under the same roof received a good part of the blame for the Great Crash (see one of my favorite books, *Wall Street Under Oath* by Ferdinand Pecora, 1939). This led to passage of the Glass-Steagall Act mandating separation of the two. It was revoked in 1999, and when they were recombined, the battle between bankers' caution and investment bankers' risk tolerance was won by the latter, putting institutions that were "too big to fail" in jeopardy. This played no small part in the current crisis.

- Also in the '20s, "bucket shops" provided easy access to investment risk. They would take "side bets" on the direction of stocks from small customers without actually sending orders to the exchange. Instead, they'd throw order slips "in the bucket" and hold the risk themselves. *Voilà*: investment exposure without a stock market transaction. The other day, Charlie Munger reminded me of the similarity of bucket shops to today's derivative contracts, which likewise permit bets on investments without any actual transactions taking place in the underlying securities. Massively levered derivatives played a big part in this decade's build-up of risk.

Developments like these don't happen randomly. They're the logical next step after optimism and ardor have increased, caution has subsided, and the desire for protective regulation has abated. The relaxation of worry eventually leads to environmental changes that permit excesses.

<u>The Culmination</u>

When the long-term pendulum is at its negative extreme, it can be counted on to turn for the better at some point, passing the midpoint and continuing toward the positive part of its arc. Eventually the pendulum will reach an apex so high that it'll be incapable of staying there. Then it will swing back, whether under its own weight or because of exogenous forces, or both. **In the course of moving from merely heated to torrid, however, I believe it can be counted on to bring out behavior which is manic and dangerous.**

The current long-term cycle may have begun in the post-World War II recovery. It benefited from the positive factors discussed on pages 2 and 3 and resulted in great capital creation for consumers, homebuyers, businesses, non-profits and investors. But it continued on from "healthy" to "excessive," resulting in the events of the last eighteen months, many of which can be summed up under the heading of capital destruction.

The greatest single example may be the case of Bernard Madoff, in which a trusted, high-performing investment manager allegedly fabricated his record, deceived friends and strangers alike, and lost or stole $50 billion. An increase in fraud can be viewed as a normal component – in fact, perhaps emblematic – of frothy, cycle-driven markets. Who hears of embezzlement during bearish times? A few lines from the *Financial Times* of December 20 indicate the cyclical aspects of the Madoff affair:

> The size of the alleged Bernard Madoff scam . . . is astounding, yet unsurprising. History tells us that bubbles spawn swindles. After the biggest credit bubble of all time, we now may have the biggest swindle of all time. . . . The historian Charles Kindleberger believed that "swindling

> is demand-determined, following Keynes's law that demand determines its own supply. . . ."
>
> Mr. Madoff's story was dull . . . but compelling in a credit bubble where yields were everywhere falling. . . .
>
> When a wave of redemptions hit the Madoff funds, the Ponzi scheme . . . became unworkable. . . . Reputations inflated in the bubble [of the 1920s] promptly evaporated in the 1929 crash, which exposed a plethora of swindles. Redemptions of the hedge funds business are having the same effect today.

Having appreciated in the up cycle, mainstream securities offered only meager returns going forward, causing investors to turn elsewhere. Madoff's steady 10-11% returns wouldn't have blown off anyone's socks in the 1990s, but they were enticing in the 2000s. **Add in the optimism, credulity and loosey-goosey attitudes that always accompany the top of a cycle, and the atmosphere was right for what John Kenneth Galbraith called a good "bezzle."** But when things retreated from the lofty level that couldn't be maintained, investors put in for redemption and the falsehoods came to light.

The Madoff scam was cut from the same up-cycle-gone-wild cloth as the elimination of the uptick rule. Scams; unsupportable mortgages on overpriced homes; over-leveraged hedge funds, debt pools and buyouts; insurers with inadequate capital; managers incapable of doing what they said they could . . . as Warren Buffett says, they're all exposed when the tide goes out. What are the results to date? The outing of the biggest fraud in history; $1 trillion of write-offs by the banks thus far; $7.8 trillion committed to "recovery activities" by the U.S. alone; the biggest decline in the Dow Jones Industrials in 77 years; more than a decade of equity appreciation lost; the disappearance of every major U.S. non-bank investment bank; and a cry for more and better regulation. Now that the bursting of the credit bubble has affected the general economy, we're seeing declining consumer incomes, confidence and spending; plummeting home sales, home prices and housing starts; and the highest unemployment rate in many years. **All of this is part and parcel of the long-term cycle.**

<u>Trends Just Ahead</u>

Unlike the "era of increasing willingness," many things will face increased difficulty in the months and years just ahead. It'll be tougher times for anything dependent on:

- **bullishness, willingness and expansiveness,**
- **increasing economic activity and consumer spending,**
- **the ability to incur, service, repay or refinance debt,**
- **asset sales and the ability to delever, and**
- **strong asset values and investment returns.**

Clearly, it was in the financial world, not the "real world," that the great excesses of bullishness, willingness and expansiveness developed, planting the seeds for the current crisis. But financial-sector attitudes and innovations allowed excesses in all the things listed above to be visited upon the real world, where we're now experiencing difficulty in them. It's no coincidence that history-making excesses in the financial sector – and the correction thereof – led to history-making weakness in the real economy.

It may be a good while before the elements listed are fully restored and the long-term trend roars upward again. The government is doing everything it can to reinstate them, but there's no roadmap for success. We all have to wait with fingers crossed. However, in the coming period, while we'll be hoping for the short-term cycle to recover, it's quite likely that the long-term trends listed on pages 2 and 3 will be less salutary than they were in decades leading up to the current crisis.

When will cyclical recovery arrive? For this, too, there's no roadmap. Most economists rely for their predictions on models that extrapolate relationships between investment, production, employment and consumption, for example, but they omit psychological considerations such as bullishness, willingness and expansiveness. On January 3, a *New York Times* article reported that a survey of economists had found consensus that recovery would commence in the second half of 2009. But it added that the economists:

> . . . base their forecasts on computer models that tend to see the American economy as basically sound, even in the worst of times. That makes these forecasters generally a more optimistic lot . . . their computer models do not easily account for emotional factors like the shock from the credit crisis and falling housing prices that have so hindered borrowing and spending.
>
> Those models also take as a given that the natural state of a market economy like America's is a high level of economic activity, and that it will rebound almost reflexively to that high level from a recession.
>
> But that assumes that banks and other lenders are not holding back on loans, as they are today, depriving the nation of the credit necessary for a vigorous economy.

These forecasters might assert that their models have worked on average. But I'd guess the period during which they worked didn't include sluggishness in long-term trends of the nature I'm discussing here. **Recognizing times when historic data shouldn't be extrapolated is an important part of dealing prudently with the future.**

Importantly in this context, I want to point out that the recent decades shouldn't be considered a norm to which we're sure to return. Instead, they were the best of times. Most years saw good returns; most investments paid off (often the riskier the better); and most investors made a lot of money. The financial services industry prospered, and its people made a lot of money and had inordinate fun doing so. From 1987 to 2007, "securities, commodity contracts, and investments" grew twice as fast as total gross output. And according to *The New York Times* of December 19, in 2007, ". . . the average salary of employees [in that category] was more than four times the average salary in the rest of the economy."

In other words, it was high tide. All financial boats were lifted, obscuring who was swimming without a bathing suit. In times like those, you can make money through skill or just aggressiveness, and it's hard to tell which is which.

In my view, superior investors are the ones who make more money in the good times than they give back in the bad. The ebb tide in the next few years will show us which they were. Managers who perform relatively well for their clients in this period will be recognized and rewarded. The rest shouldn't be able to amass funds or command fees as effortlessly as they did in the past. Of course, we hope Oaktree will be among the former. We'll all know in a few years. **In the new, chastened environment, I don't think anyone will jump to conclusions as readily as they did in the past.**

The other day, I was speaking with a reporter who summed up what I had said: "So skepticism will be greater; investors will be more risk-averse; fund raising will be harder; and fees will receive more scrutiny. That'll be worse for business, right?" For the short run and for managers who failed their clients, it likely will. **But in the long run, it'll make for a much healthier environment for all of us.**

<u>The Importance of the Long View</u>

As usual, some of the most important lessons concern the need to (a) study and remember the events of the past and (b) be conscious of the cyclical nature of things. Up close, the blind man may mistake the elephant's leg for a tree – and the shortsighted investor may think an uptrend (or a downtrend) will go on forever. But if we step back and view the long sweep of history, we should be able to bear in mind that the long-term cycle repeats and understand where we stand in it. The failure to do so can be most painful. John Kenneth Galbraith provided a reminder in *A Short History of Financial Euphoria*:

> 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, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. 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 the insight to appreciate the incredible wonders of the present.

Jim Grant did a good job of putting a cyclical movement into perspective in the January 31, 2003 issue of *Grant's Interest Rate Observer*:

> Wall Street today is in one of its recurrent sinking spells. Many call it a crisis of confidence, by which they mean under-confidence. Less attention is given to the preceding crisis of overconfidence. Material progress is cumulative, but markets are cyclical. First, investors trust too much, then they doubt too much. They believe that no price is too high to pay for a stock or a bond, then they doubt that any price is too low. So credulity is followed by cynicism, unreasonably high prices by ridiculously low ones.

Central banks will try to stabilize economies, and company managers will strive for smooth earnings growth. But as long as human beings determine security prices, market cycles will be the rule, not the exception. The extremes of greed, fear and worry over missing out will never be banished.

At times investors will be too risk-tolerant, and at others they'll be too risk-averse. They'll forget to inquire skeptically after things have gone well for a while, just as they'll ask too many questions and hesitate too much when recent events have decimated securities prices (and investors' psyches). **As little as two years ago, investors rushed headlong into things, fearing that if they didn't, they'd miss out on big gains. Now they're keeping their money in their wallets, saying "I don't care if I ever make a penny in the market again, I just don't want to lose any more." This change in attitudes – throughout the financial system – is responsible for a lot of today's deep freeze.**

Over the last several decades, our economy and markets benefited from positive underlying trends and investors were well rewarded for bearing risk. As a result, there was rising bullishness, willingness and expansiveness. When these trends reached unsustainable excesses, they were corrected with a vengeance. **I'm now of the opinion that not only will short-term economic cycles of boom and bust repeat regularly, but also that favorable long-term trends are bound to see a recurrence of this sort of occasional massive pullback . . . at that moment when the passage of time has erased all memory of past corrections and taken investor behavior (and thus asset prices) to unsustainable highs.**

Buoyant, decades-long up-trends and their explosive endings are the inevitable results of the tendency of human nature to go to extremes. Hopefully the current bursting of the long-term bubble will end within the next few years, and hopefully the next iteration is another 30, 50 or 70 years away. This one's providing enough excitement for a lifetime.

January 9, 2009

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Memo to: Oaktree Clients

From: Howard Marks

Re: Will It Work?

The other day, my son Andrew – college senior and credit-analyst-to-be – asked whether I think Treasury Secretary Geithner is doing the right things. As has happened before, his question elicited a fatherly response that grew into this memo.

When you want a bridge built, you hire a civil engineer whose "calcs" will determine exactly how much concrete and steel should be used. Then it'll be sure to hold the weight of the cars you expect to cross it. And if you have to perform a task in carpentry, you can employ specialized tools developed and tested expressly for the job: esoteric things like miter boxes, routers and extractors.

One of the most important things to bear in mind today is that **economics isn't an exact science.** It may not even be much of a science at all, in the sense that in science, controlled experiments can be conducted, past results can be replicated with confidence, and cause-and-effect relationships can be depended on to hold. It's not for nothing that economics is called "the dismal science."

Solutions in economics aren't nearly as dependable as engineers' calculations, and there may not be a tool that's just right for fixing an economy. Of course, the toolbox offers lots of possibilities, including interest rate reductions; quantitative easing; tax cuts, rebates and credits; stimulus checks; infrastructure spending; capital injections; loans, rescues and takeovers; regulatory forebearances and on and on. **But no one should think there's a "golden tool," such that solving the problem is just a matter of figuring out which one it is and applying it.** Anyone who holds the problem solvers to that standard is being unfair and unrealistic. There are a number of reasons why, including these:

- Every situation is different, and none is exactly like any that has come before. That means fixed recipes can't work. Certainly this one has never been seen before.
- Most policy actions aren't all good or all bad. They merely represent imperfect compromises as to ideology, goals, problem solving and resource allocation.
- Economic problems are multi-faceted, meaning the solution for one aspect might not work on – and in fact might exacerbate – another aspect.
- Economies are dynamic, and the problems are moving targets. The environment changes constantly, rather than sitting still and waiting for a solution to work.
- **The main ingredient in economics is psychology, and the workings of psychology clearly can't be fully known, controlled or fixed.**

Here's how Thomas Friedman put it in *The New York Times* of January 31:

> Everyone is looking for the guy – the guy who can tell you exactly what ails the world's financial system, exactly how we get out of this mess and exactly what you should be doing to protect your savings. . . . But here's what's really scary: the guy isn't here. He's left the building. . . .
>
> There is no magic bullet for this economic crisis, no magic bailout package, no magic stimulus. We have woven such a tangled financial mess with subprime mortgages wrapped in complex bonds and derivatives, pumped up with leverage, and then globalized to the far corners of the earth that, much as we want to think this will soon be over, that is highly unlikely.

The "I know" school (which first appeared in a memo in 2001) is still making predictions. Statistical comparisons are being made to past recessions and solutions extrapolated from those experiences. Thus it's the consensus of this school that the recovery will start during the first quarter of 2010. I also see people projecting a stock market rebound based on the average time between past declines and the recoveries therefrom.

I think it's a mistake to hold confident opinions about the events of today. Instead, I think this is a great time to reaffirm faith in the "I don't know" school, of which I'm a card-carrying member. No one should feel certain they know what's going to unfold, or when. **<u>The only things we have to fall back on at this juncture are intrinsic value, company survival and our own staying power as investors</u>. Of course, even these things mean we have to make judgments about what the future is likely to look like. That requirement, in turn, means nothing can be approached with complete safety or certainty. Nevertheless, we can take action if we think those three elements will be present under most circumstances. That's the right mindset for today.**

<u>Harder Than Sudoku</u>

The impossibility of reaching into the economic toolbox for that one perfect tool is easily illustrated with a list of some of the challenges present today. For a learning exercise, skip today's Sudoku or crossword puzzle and take a crack at resolving these dilemmas:

- Consumer confidence and spending are weak. We want to stimulate, but we don't want to replace weakness with hyperinflation.
- We're willing to drop fiscal discipline in favor of stimulus through deficit spending, but we don't want to scare away offshore investors from the Treasury securities we'll issue to fund our deficits.
- We're willing to distribute stimulus checks, but we seem unable to make frightened individuals spend the money rather than save it.
- In fact, we know consumers got into trouble by spending more than they earned, and

now they should build some savings. But whereas in the recent past consumer spending grew faster than incomes, a rising savings rate means spending would grow slower than incomes, just at a time when incomes are falling and spending is needed.

- Likewise, with tax revenues down, states and cities have to balance their budgets. One way to do so is to raise income tax and sales tax rates, but this will further depress local economies and increase the burden on their beleaguered citizens.
- We want to recapitalize the banks, but we don't want to reward past mistakes.
- We're thinking about buying the banks' "toxic" assets. But if we pay above-market prices, that's a subsidy to the reckless (see above), and if we pay market or below-market prices, that will further erode bank capital through write-downs.
- We know suspending mark-to-market accounting would end write-downs, but doing so might also reduce confidence in balance sheets and postpone the day of reckoning needed for our financial institutions to reach bottom and recover.
- We want the banks to lend, but we can't – and shouldn't – make them extend loans to non-creditworthy borrowers.
- We want to reduce the incidence of home foreclosure, but we don't want to reward people who speculated by buying multiple homes or lied on mortgage applications. And we'd rather not treat people who bought more house than they could afford better than those who acted prudently.
- We want to make mortgage relief available to those who are unable to service their mortgages, but we don't want to give people incentives to stop making payments.
- We're considering letting bankruptcy judges reset mortgage contracts, but we don't want to tell lenders that loan contracts are no longer sacrosanct, which certainly would deter them from making new loans.
- We don't want the depressant impact of auto companies going bankrupt and suppliers and dealers following suit. But we also don't want to pump money into the industry unless we're confident it can produce good cars at competitive prices.
- We want to see the auto industry "rationalized," but that means seeing people lose their jobs or have their paychecks reduced, which would spread pain, put stress on benefit funds, and cut into GDP.
- We want taxpayer-supported automakers to use American steel, but (assuming it's more expensive than imported steel) that will either (a) raise car prices, making cars more expensive for hard-pressed buyers and making the Big 3 less competitive, or (b) require the companies to eat the difference, making it harder for them to achieve profitability.
- We want to curb speculation in derivatives, but we don't want to make it harder for businesses, farmers, insurers and investors to legitimately hedge risk.
- In fact, we want to prevent excesses on the part of business, but most people don't think it's a good idea to nationalize companies or have the government tell them how to operate.

It's abundantly clear from this list – and it's only a partial list – that solving the current problem will require compromises and a combination of disparate elements. Some will work, while others will fail and have to be replaced. And some will work with regard to one facet of the problem but aggravate another. Lastly, no one should think that even a wise combination will produce quick results.

Regulating Excess Compensation

Some of the excesses the government wants to stop are in the area of compensation at rescued banks. Excessive compensation seems to have a lot in common with hard-core pornography: As Potter Stewart, Associate Justice of the United States Supreme Court, wrote about the latter, it's hard to define but "I know it when I see it."

It's easy to react adversely when an institution that lost billions and needed a taxpayer bailout is seen paying millions or billions in executive bonuses. But how do we define excessive compensation, and what should be done about it? **More importantly, how do we make sure the cure won't be worse than the disease?**

On February 14, *The Wall Street Journal* reported that,

> The giant stimulus package that cleared Congress Friday includes a last-minute addition that restricts bonuses for top earners at firms receiving federal cash . . . The most stringent pay restriction bars any company receiving funds from paying top earners bonuses equal to more than one-third of their total annual compensation.

Some limitation on compensation at taxpayer-supported institutions seems reasonable and unavoidable. But is this provision a good thing? Here are some of the problems:

- It doesn't limit compensation, just bonuses.
- **Bonuses – especially if tied to achievements – should be preferable to high salaries from the point of view of shareholders and taxpayers**. In fact, it was just a few years ago that federal legislation created a preference for incentive compensation tied to benchmarks.
- An executive with a $1 million salary is in compliance with this restriction if he receives a bonus of $500,000. But one who's paid $250,000 is in violation if he receives a bonus of $200,000. Should the taxpayer prefer the former to the latter?
- Past challenges, like mobilizing industry for World War II, were met by recruiting "dollar-a-year" leaders. **One hope here might be that able businesspeople will come forward to work for nothing but a big success fee**. Citigroup CEO Vikram Pandit is receiving a salary of $1. Should we really limit his bonus to 50 cents?
- **The new law will limit bonuses at taxpayer-assisted banks, not all banks. Will that doom the rescued banks to second-rate management? And thus second-rate profitability? Is that desirable?**
- **Bank managements and boards may want to avoid this limitation, and to do that they may turn down or rush to repay federal money. Doing so may reduce the banks' capital, weakening them and inhibiting their ability to lend.**
- Even the biggest losers among the banks had some profitable units and excellent managers. Do we want the weak institutions to lose these to their stronger peers because they can't pay competitively?
- **Does the fact that some bank managers made grave mistakes in recent years mean no bank executives can be deserving of high compensation? Does the**

government really want to stigmatize the field of banking and chase able executives from it to industries where compensation is unregulated?

- The last time I saw legislation with near-unanimous appeal on a corporate-behavior issue was in 2002, after the Enron scandal. American business is still suffering from some of Sarbanes-Oxley's less-well-conceived provisions.

Observers are disappointed when recovery plans aren't announced quickly or in detail. Yet here's a provision that was inserted quickly and in detail, and it doesn't do a lot to advance the ball. Bottom line: a quick fix will prove hard to come by.

Who's Right?

My mother used to tell a story about the *shtetls* – villages – in the old country where disagreements were settled by the rabbi. In one, an argument was raging with no possible grounds for compromise. The villagers brought the two parties to the rabbi. "Tell your side," the rabbi said to one fellow, and he did. "**You're right**," the rabbi declared.

One of the bystanders piped up: "You can't tell him he's right, rabbi; you haven't heard the other side of the story." So the rabbi told the other party to tell his side, and he did. His story was the polar opposite of the other party's. "**You're right**," said the rabbi.

"Hold on, rabbi," a villager said, "the first guy told his story and you said he was right. Then the other guy told his story – different in every regard – and you said he was right. They both can't be right." "**And you're right**," said the rabbi.

The current disagreement over bank nationalization shows that (a) there can be valid arguments on both sides of an issue and (b) it can be hard to figure out who's right. Here are a few of the pros and cons as advanced by *The Wall Street Journal* on February 24:

> **What are the pluses to nationalizing firms?**
>
> Some banks are bleeding slowly toward insolvency. Nationalizing them promptly would allow the government to wipe out the most toxic assets, reorganize what is left and sell the remains to private investors. On a broader front, nationalization could help heal the banking system and encourage the remaining firms to boost lending.
>
> **What are the minuses?**
>
> Investors in the nationalized bank would likely be wiped out. And nationalizing even one or two banks could create a chain reaction of failing confidence. . . .
>
> Nationalization would also be expensive and complicated, taxing a bureaucracy that isn't set up to operate mega-firms. And while the goal of

> nationalization may be to return companies to private hands, the temptation to run them for political purposes would be immense.

Obviously, there are arguments on both sides.

<u>One Proposal</u>

The other night, I had dinner with my friend Richard Ressler, principal and founder of CIM Group. He has an idea as to how things can be fixed (as usual), and it's a pretty good one. I'll summarize below his thoughts on the banking industry:

- There are banking institutions which, because of their magnitude and significance, should be supported through deposit insurance, government guarantees and rescues.
- These banks should engage only in the prosaic acts of accepting deposits and making loans. They should not take on ultra-high leverage or make exotic investments. And they shouldn't do business through unregulated, off-balance-sheet subsidiaries.
- Institutions that wish to do things that are off-limits to these banks should do so, but without the benefit of government protection. If they want to take on 30-times leverage and pursue proprietary profits, they should bear the consequences themselves.
- Thus banking and risky investing should be separated.

In *The New York Times* of February 2, Professor Paul Krugman of Princeton argued that we have to avoid "lemon socialism: taxpayers bear the cost if things go wrong, but stockholders and executives get the benefits if things go right." One way to prevent this, as Richard suggests, is to make sure government support and high-octane risk taking don't take place in the same firms.

I've been told it isn't his, but a saying widely attributed to Mark Twain seems to be on the mark: "History doesn't repeat itself, but it does rhyme." There's no need to invent the mechanism through which to accomplish the above; we can look to history and gain inspiration from the Glass-Steagall Act.

After the Great Crash, congressional committees investigated its causes, some of which remind one of today's. The result was this 1933 law, which mandated that banking be separated from investment banking and investment services. It's far from irrelevant to the current situation that Glass-Steagall's powers ended in 1999, when key parts were repealed by the Gramm-Leach-Bliley Act. This new law had the goal of encouraging competition in banking, investment services and insurance, by permitting common ownership by financial conglomerates.

Protecting society against risky investment activities on the part of government-insured institutions is a good thing. And competition in providing financial services is a good thing. But the two goals can be in conflict and have to be balanced, and the consensus as to which should prevail will oscillate from time to time. **So in addition to**

there not being perfect solutions, there also may not be permanent solutions. That's why crises will recur and history will continue to rhyme.

Politics as Usual

Few phrases strike terror in the hearts of businesspeople and many just-plain-citizens more than the three little words that are the title of this section. The other day, a friend with high-up experience explained the facts of life in Washington. He organized his observations into the "Three P's."

- **Policy** is fashioned through intellectual debate conducted on a high plane. Well-meaning people can disagree, but policy analysis follows from facts and underlying ideology in a relatively straightforward way.
- **Process** is the mechanism through which policy is turned into action. It is complex and arcane and the exclusive province of people with experience in Washington.
- **Politics** shapes the law that policy becomes. My friend had lots of words for it, but the one that stood out to me was "distasteful."

As an aside, my friend laid out an important difference between government and business, in which he's also highly experienced. **In business, he says, everyone's main goal is the success of the company.** Contributing to the success of the company enables an individual to demonstrate ability and thus rise in the organization. Success for the company creates a pool of profits from which the individual can be well paid. It also amounts to a "win" for a team of which every person wants to be a member.

But in government, success is hard to measure, difficult to connect to any one individual's contribution, and slow in coming. Thus it's hard to view success for the government as constituting elected officials' primary motivation. Instead, the most important thing is getting re-elected. That personal, short-term consideration can have nothing to do with the long-term well-being of the nation. This is especially true in the House of Representatives, he says, where two-year terms mean the members are never done running for re-election.

Despite the crisis facing the country and the crying need for prompt action, we're seeing a good dose of politics as usual. YouTube provides an up-close look at this stuff. It also gives politicians the audience many seem to crave.

Today a lynch-mob attitude prevails toward bankers, mortgage lenders and credit-rating agencies. I'm not saying a lot of it isn't deserved, but it still can be overdone. It's always good political theater to pile on a purported villain, whether through a perp-walk for handcuffed inside traders in 1986 or a televised congressional hearing for bankers in 2009.

Check out Congress's grilling of bankers on YouTube and you'll see what I think is vilification and *ad hominem* attack ("appealing to one's prejudices, emotions, or special interests rather than to one's intellect or reason" – Random House Dictionary) intended for public consumption. One congressman told Vikram Pandit, Citibank's CEO, he was amazed by a deal the bank had made: "The government gets $7 billion in preferred stock and the government's on the hook for $250 billion of losses. . . . You tell me, Mr. Pandit: where can I get a deal like this?" Pandit explained that it was insurance: for a premium of $7 billion, Citibank got a policy covering $301 billion of mortgage securities, with Citi taking the first $30 billion of losses and 10% of any losses beyond that.

Should it come as a surprise that an insurance policy costs significantly less to buy than the amount of risk assumed by the insurer? If it didn't, why would anyone buy one? Under this policy, Citi will lose money if there aren't $38 billion in losses (in which case Citi would receive nothing on the first $30 billion but 90% of the next $8 billion, so proceeds would be equal to the $7 billion premium it had paid). Was this deal really such a giveaway? And should the Congressman really be surprised to learn the government has a preference for seeing Citi survive and is willing to cut it a good deal?

On the campaign trail and in victory, President Obama called for non-partisanship and united action. With Democrats controlling the White House and Congress, to him that means Republicans should vote in favor of solutions crafted primarily by Democrats. So far, it's not happening. On the stimulus package, only three of the 217 Republican votes in Congress – just over one percent – were cast with the Democratic majority. (And only seven of the 308 Democratic votes went with the Republicans.) Not much aisle crossing in either direction. Of course, there are lots of reasons why broad agreement is rarely seen:

- Genuine **ideological differences** exist between individuals and between parties. Some want an expanded government to fix problems, and others prefer to rely on free markets to do so. Some view increased government spending as holding the key to the solution, and others prefer to reduce taxes. Some want to rescue weak financial institutions, and others want only the strongest, best-run to survive. Thus, failing to go along with the majority isn't necessarily a sign of a character flaw.

- There are also valid **differences in motivation**. The president is a national officer whose job it is to find an overall solution. But legislators are elected locally to represent local interests, and those can diverge from the interests of other regions or the nation. It shouldn't come as a surprise that they push for particular benefits for their constituents.

- Finally there comes **self-interest**. The truth is that each party has the underlying goal of wanting to elect its members and make the other side look bad. And even if it's needed to solve a grave national problem, a conservative answer might be repugnant and unacceptable to voters in a liberal district, and vice versa. Thus, doing the "right thing" can be tantamount to political suicide. How many elected officials will choose the latter?

Today's Rhetoric

I think people in government who're addressing the situation have a difficult row to hoe:

- First and most immediately, they've had to play up the emergency in order to convince legislators (and the voters who put them in office) that the situation is dire and strong action is required. Thus we've heard words like "catastrophe," "collapse" and "worst since the Great Depression."

- Second, however, they're well advised to play down the threat. Franklin D. Roosevelt receives a lot of credit for having said, "The only thing we have to fear is fear itself." Given the crucial role of confidence in the functioning of an economy, it's not a great idea to spread panic. The rational response of frightened people is to save rather than spend, and to sell investments rather than buy, making things worse.

- Third, the President likely wants to create modest expectations. If there's a feeling that a valid response should work right away, slow progress will look like failure. No one wants consumers and businesses to further pull in their horns if economic recovery isn't forthcoming in 2009.

It's hard not to be sympathetic to this dilemma. It shows another of the ways in which conflicting goals have to be compromised in the real world of economics and politics.

The Bottom Line

There are so many moving parts to the current situation – and to its causes and what we hope will be its solution – that I've tried to boil things down to the essentials. **In order to right the system and get the economy moving forward again, I think three main things have to be accomplished:**

- **Our economy and its component parts have to be delevered;**
- **The vast destruction of capital has to be dealt with; and**
- **Confidence has to be restored.**

Here's how Paul Krugman described the challenge in *The New York Times* of February 16:

> For most of the last decade America was a nation of borrowers and spenders, not savers. . . .
>
> Yet until very recently Americans believed they were getting richer, because they received statements saying that their houses and stock portfolios were appreciating in value faster than their debts were increasing. . . .

> Then reality struck, and it turned out that the worriers had been right all along. The surge in asset values had been an illusion – but the surge in debt had been all too real. . . .
>
> . . . this is a broad-based mess. Everyone talks about the problems of the banks, which are indeed in even worse shape than the rest of the system. But the banks aren't the only players with too much debt and too few assets; the same description applies to the private sector as a whole.
>
> As the great American economist Irving Fisher pointed out in the 1930s, the things people and companies do when they realize they have too much debt tend to be self-defeating when everyone tries to do them at the same time. Attempts to sell assets and pay off debt deepen the plunge in asset prices, further reducing net worth. Attempts to save more translate into a collapse of consumer demand, deepening the economic slump.
>
> . . . Government officials understand the issue: we need to "contain what is a very damaging and potentially deflationary spiral," says Lawrence Summers, a top Obama economic adviser.

Debt has to be reduced, and it's happening (other than at the federal level, of course). But the way it happens is usually unpleasant: bankruptcies, foreclosures and debt restructurings. **"Debt reduction" sounds like a good thing, but it's likely to be accompanied by the painful loss of the assets that had been bought with borrowed money.**

Many assets are worth far less than they used to be – that's one of the main reasons why the debt load has become unbearable and has to be reduced. **Investors, consumers, homeowners and financial institutions will have to rebuild their capital as they – and the economy – attempt to again move ahead.**

And confidence has to be rebuilt, too. **The willingness to borrow, spend and invest will rebound only when people believe incomes and asset values will resume their growth.**

In the past, we've seen a standard pattern unfold, with the best examples falling in the corporate debt arena. **Once denial ends and people accept capital destruction as a fact, restructurings can take place in which debt is discharged and ownership changes hands. The transition of assets to new owners, who may have lower cost bases and the ability to inject additional capital, brings the possibility of attractive returns, the onset of which restores interest in investing. It seems inescapable that this pattern will be a major feature of the next few years.**

The government's actions clearly are aimed at accomplishing the three things I say we need. Some will work, and some won't. **I believe that, eventually, the combination of things they try – along with the pattern described above and the positive bent that**

underlies the free market system – will return us to an upward trajectory. It just won't be easy, quick or painless.

And that's why I think the investment decisions we make today must emphasize <u>value</u>, <u>survivability</u> and <u>staying</u> <u>power</u>. I readily acknowledge that assuring survival in bad times is inconsistent with return maximization in good times. Insistence on these three things won't produce the greatest rewards if the economy and markets surprise on the upside, but that's not my main concern.

Given the uncertainty present today, it's hard enough to find investments that can be relied on to deliver solid returns in good times but also assure survival in bad. **In that interest, we've always been willing to cede to others much of that part of the return distribution lying between "solid" and "maximum." This time is no different.**

March 5, 2009

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Memo to: Oaktree Clients

From: Howard Marks

Re: So Much That's False and Nutty

As reported in *The New York Times* of May 5, Warren Buffett told the crowd at this year's Berkshire Hathaway annual meeting:

> There is so much that's false and nutty in modern investing practice and modern investment banking. If you just reduced the nonsense, that's a goal you should reasonably hope for.

As we look back at the causes of the crisis approaching its second anniversary – and ahead to how investors might conduct themselves better in the future – Buffett's simple, homespun advice holds the key, as usual. I agree that investing practice went off the rails in several fundamental ways. Perhaps this memo can help get it back on.

The Lead-up: Progress and Missteps

Memory dims with the passage of time, but when I think back to the investment arena I entered forty-plus years ago, it seems very different from that of 2003-07. Institutional investing was done mainly by bank investment departments (like the one I was part of), insurance companies and investment counselors – a pretty dull bunch. And as I like to point out when I speak to business school classes, "famous investor" was an oxymoron – few investment managers were well known, chosen for magazine covers or listed among the top earners.

There were no swaps, index futures or listed options. Leverage wasn't part of most institutional investors' arsenal . . . or vocabulary. Private equity was unknown, and hedge funds were too few and outré to matter. Innovations like quantitative investing and structured products had yet to arrive, and few people had ever heard of "alpha."

Return aspirations were modest. Part of this likely was attributable to the narrow range of available options: for the most part stocks and bonds. Stocks would average 9-10% per year, it was held, but we might put together a portfolio that would do a little better. And the admissible bonds were all investment grade, yielding moderate single digits.

We wanted to earn a good return, limit the risks, beat the Dow and our competitors, and retain our clients. But I don't remember any talk of "maximization," or anyone trying to "shoot the lights out." And by the way, no one had ever heard of performance fees. Quite a different world from that of today. Perhaps it would constitute a service if I pulled together a list of some of the developments since then:

- In the mid-1960s, **growth investing** was invented, along with the belief that if you bought the stocks of the "nifty-fifty" fastest-growing companies, you didn't have to worry about paying the right price.
- The first of the **investment boutiques** was created in 1969, as I recall, when highly respected portfolio managers from a number of traditional firms joined together to form Jennison Associates. For the first time, institutional investing was sexy.
- We started to hear more about **investment personalities**. There were the "Oscars" (Schafer and Tang) and the "Freds" (Carr, Mates and Alger) – big personalities with big performance, often working outside the institutional mainstream.
- In the early 1970s, **modern portfolio theory** began to seep from the University of Chicago to Wall Street. With it came indexation, risk-adjusted returns, efficient frontiers and risk/return optimization.
- Around 1973, put and call **options** escaped from obscurity and began to trade on exchanges like the Chicago Board Options Exchange.
- Given options' widely varying time frames, strike prices and underlying stocks, a tool for valuing them was required, and the **Black-Scholes model** filled the bill.
- A small number of **leveraged buyouts** took place starting in the mid-1970s, but they attracted little attention.
- 1977-79 saw the birth of the **high yield bond market**. Up to that time, bonds rated below investment grade couldn't be issued. That changed with the spread of the argument – associated primarily with Michael Milken – that incremental credit risk could responsibly be borne if offset by more-than-commensurate yield spreads.
- Around 1980, **debt securitization** began to occur, with packages of mortgages sliced into securities of varying risk and return, with the highest-priority tranche carrying the lowest yield, and so forth. This process was an example of disintermediation, in which the making of loans moved out of the banks; 25 years later, this would be called the **shadow banking system.**
- One of the first "quant" miracles came along in the 1980s: **portfolio insurance**. Under this automated strategy, investors could ride stocks up but avoid losses by entering stop-loss orders if they fell. It looked good on paper, but it failed on Black Monday in 1987 when brokers didn't answer their phones.
- In the mid- to late 1980s, the ability to borrow large amounts of money through high yield bond offerings made it possible for minor players to effect buyouts of large, iconic companies, and "**leverage**" became part of investors' everyday vocabulary.
- When many of those buyouts proved too highly levered to get through the 1990 recession and went bust, investing in **distressed debt** gained currency.
- Real estate had boomed because of excessive tax incentives and the admission of real estate to the portfolios of S&Ls, but it collapsed in 1991-92. When the Resolution Trust Corporation took failed properties from S&Ls and sold them off, **"opportunistic" real estate** investing was born.
- Mainstream investment managers made the big time, with Peter Lynch and Warren Buffett becoming famous for consistently beating the equity indices.
- In the 1990s, **emerging market investing** became the hot new thing, wowing people until it took its knocks in the mid- to late 1990s due to the Mexican peso devaluation, Asian financial crisis and Russian debt disavowal.

- **Quant investing** arrived, too, achieving its first real fame with the success of Long-Term Capital Management. This Nobel Prize-laden firm used computer models to identify fixed income arbitrage opportunities. Like most other investment miracles, it worked until it didn't. Thanks to its use of enormous leverage, LTCM melted down spectacularly in 1998.
- Investors' real interest in the last half of the '90s was in **common stocks,** with the frenzy accelerating but narrowing to **tech-media-telecom stocks** around 1997 and narrowing further to **Internet stocks** in 1999. The "limitless potential" of these instruments was debunked in 2000, and the equity market went into its first three-year decline since the Great Crash of '29.
- **Venture capital funds**, blessed with triple-digit returns thanks to the fevered appetite for tech stocks, soared in the late 1990s and crashed soon thereafter.
- After their three-year slump, the loss of faith in common stocks caused investors to shift their hopes to **hedge funds** – "absolute return" vehicles expected to make money regardless of what went on in the world.
- With the bifurcation of strategies and managers into "beta-based" (market-driven) and "alpha-based" (skill-driven), investors concluded they could identify managers capable of **alpha investing**, emphasize it, perhaps synthesize it, and "port" or carry it to their portfolios in additive combinations.
- **Private equity** – sporting a new label free from the unpleasant history of "leveraged buyouts" – became another popular alternative to traditional stocks and bonds, and funds of $20 billion and more were raised at the apex in 2006-07.
- Wall Street came forward with a plan to package prosaic, reliable home mortgages into **collateralized debt obligations** – the next high-return, low-risk free lunch – with help from tranching, securitization and selling onward.
- The key to the purported success of this latest miracle lay in **computer modeling**. It quantified the risk, assuming that mortgage defaults would remain uncorrelated and benign as historically had been the case. But because careless mortgage lending practices unknowingly had altered the probabilities, the default experience turned out to be much worse than the models suggested or the modelers thought possible.
- Issuers of **collateralized loan obligations** bought corporate loans using the same processes that had been applied to CDOs. Their buying facilitated vast issuance of syndicated bank loans carrying low interest rates and few protective covenants, now called **leveraged loans** because the lending banks promptly sold off the majority.
- Options were joined by futures and swaps under a new heading: **derivatives**. Heralded for their ability to de-risk the financial system by shifting risk to those best able to bear it, derivatives led to vast losses and something new: counterparty risk.
- The common thread running through hedge funds, private equity funds and many other of these investment innovations was **incentive compensation**. Expected to align the interests of investment managers and their clients, in many cases it encouraged excessive risk taking.
- Computer modeling was further harnessed to create **"value at risk"** and other risk management tools designed to quantify how much would be lost if the investment environment soured. This fooled people into thinking risk was under control – a belief that, if acted on, has the potential to vastly increase risk.

At the end of this progression we find an institutional investing world that bears little resemblance to the quaint cottage industry with which the chronology began more than forty years ago. Many of the developments served to increase risk or had other negative implications, for investors individually and for the economy overall. In the remainder of this memo, I'll discuss these trends and their ramifications.

Something for Everyone

One thing that caused a lot of people to lose money in the crisis was the popularization of investing. Over the last few decades, as I described in "The Long View" (January 2009), investing became widespread. "Less than 10% of adults owned stocks in the 1950s, in contrast to 40% today." (*Economics and Portfolio Strategy*, June 1, 2009). Star investors became household names and were venerated. "How-to" books were big sellers, and investors graced the covers of magazines. Television networks were created to cover investing 24/7, and Jim Cramer and the "Money Honey" became celebrities in their own right.

It's interesting to consider whether this "democratization" of investing represented progress, because in things requiring special skill, it's not necessarily a plus when people conclude they can do them unaided. The popularization – with a big push from brokerage firms looking for business and media hungry for customers – was based on success stories, and it convinced people that "anyone can do it." **Not only did this overstate the ease of investing, but it also vastly understated the danger**. ("Risk" has become such an everyday word that it sounds harmless – as in "the risk of underperformance" and "risk-adjusted performance." Maybe we should switch to "danger" to remind people what's really involved.)

To illustrate, I tend to pick on Wharton Professor Jeremy Siegel and his popular book "Stocks for the Long Run." Siegel's research was encyclopedic and supported some dramatic conclusions, perhaps foremost among them his showing that there's never been a 30-year period in which stocks didn't outperform cash, bonds and inflation. This convinced a lot of people to invest heavily in stocks. But even if his long-term premise eventually holds true, anyone who invested in the S&P 500 ten years ago – and is now down 20% – has learned that 30 years can be a long time to wait.

The point is that not everyone is suited to manage his or her own investments, and not everyone should take on uncertain investments. The success of Bernard Madoff's Ponzi scheme shows that even people who are wealthy and presumed sophisticated can overlook risks. Might that be borne in mind the next time around?

At Ease with Risk

Risk is something every investor should think about constantly. We know we can't expect to make money without taking chances. The reason's simple: if there was a risk-free way to make good money – that is, a path to profit free from downside – everyone would pursue it without hesitation. That would bid up the price, bring down the return and introduce the risk that accompanies elevated prices.

So yes, it's true that investors can't expect to make much money without taking risk. But that's not the same as saying risk taking is sure to make you money. As I said in "Risk" (January 2006), if risky investments always produced high returns, they wouldn't be risky.

The extra return we hope to earn for holding stocks rather than bonds is called an equity risk premium. The additional promised yield on high yield bonds relative to Treasurys is called a credit risk premium. All along the upward-sloping capital market line, the increase in potential return represents compensation for bearing incremental risk. Except for those people who can generate "alpha" or access alpha managers, investors shouldn't plan on getting added return without bearing incremental risk. And for doing so, they should demand risk premiums.

But at some point in the swing of the pendulum, people usually forget that truth and embrace risk taking to excess. In short, in bull markets – usually when things have been going well for a while – people tend to say, "Risk is my friend. The more risk I take, the greater my return will be. I'd like more risk, please."

The truth is, risk tolerance is antithetical to successful investing. When people aren't afraid of risk, they'll accept risk without being compensated for doing so . . . and risk compensation will disappear. This is a simple and inevitable relationship. When investors are unworried and risk-tolerant, they buy stocks at high p/e ratios and private companies at high EBITDA multiples, and they pile into bonds despite narrow yield spreads and into real estate at minimal "cap rates."

In the years leading up to the current crisis, it was "as plain as the nose on your face" that prospective returns were low and risk was high. In simple terms, there was too much money looking for a home, and too little risk aversion. Valuation parameters rose and prospective returns fell, and yet the amount of money available to managers grew steadily. Investors were attracted to risky deals, complex structures, innovative transactions and leveraged instruments. In each case, they seemed to accept the upside potential and ignore the downside.

There are few things as risky as the widespread belief that there's no risk, because it's only when investors are suitably risk-averse that prospective returns will incorporate appropriate risk premiums. Hopefully in the future (a) investors will remember to fear risk and demand risk premiums and (b) we'll continue to be alert for times when they don't.

Embracing Illiquidity

Among the risks faced by the holder of an investment is the chance that if liquidity has dried up at a time when it has to be sold, he'll end up getting paid less than it's worth. **Illiquidity is nothing but another source of risk, and it should be treated no differently**:

- All else being equal, investors should prefer liquid investments and dislike illiquidity.
- Thus, before making illiquid investments, investors should ascertain that they're being rewarded for bearing that risk with a sufficient return premium.
- Finally, out of basic prudence, investors should limit the proportion of their portfolios committed to illiquid investments. There are some risks investors shouldn't take regardless of the return offered.

But just as people can think of risk as a plus, so can they be attracted to illiquidity, and for basically the same reason. There is something called an illiquidity premium. It's the return increment investors should receive in exchange for accepting illiquidity. But it'll only exist if investors prefer liquidity. If they're indifferent, the premium won't be there.

Part of the accepted wisdom of the pre-crisis years was that long-term institutional investors should load up on illiquid investments, capitalizing on their ability to be patient by garnering illiquidity premiums. In 2003-07, so many investors adopted this approach that illiquidity premiums became endangered. For example, as of the middle of 2008, the average $1 billion-plus endowment is said to have had investments in and undrawn commitments to the main illiquid asset classes (private equity, real estate and natural resources) equal to half its net worth. Some had close to 90%.

The willingness to invest in locked-up private investment funds is based on a number of "shoulds." Illiquid investments should deliver correspondingly higher returns. Closed-end investment funds should call down capital gradually. Cash distributions should be forthcoming from some funds, enabling investors to meet capital calls from others. And a secondary market should facilitate the sale of positions in illiquid funds, if needed, at moderate discounts from their fair value. But things that should happen often fail to happen. That's why investors should view potential premium returns skeptically and limit the risk they bear, including illiquidity.

Comfortable with Complexity

Investors' desire to earn money makes them willing to do things they haven't done before, especially if those things seem modern and sophisticated. Technological complexity and higher math can be seductive in and of themselves. And good times and rising markets encourage experimentation and erase skepticism. These factors allow Wall Street to sell innovative products in bull markets (and only in bull markets). But these innovations can be tested only in bear markets . . . and invariably they are.

Many of the investment techniques that were embraced in 2003-07 represented quantitative innovations, and people seemed to think of that as an advantage rather than a source of potential risk. Investors were attracted to black-box quant funds, highly levered mortgage securities critically dependent on computer models, alchemical portable alpha, and risk management based on sketchy historical data. The dependability of these things was shaky, but the risks were glossed over. As Alan Greenspan wrote in *The Wall Street Journal* of March 11:

> It is now very clear that the levels of complexity to which market practitioners at the height of their euphoria tried to push risk-management techniques and products were too much for even the most sophisticated market players to handle properly and prudently.

Warren Buffett put it in simpler terms at this year's Berkshire meeting. "**If you need a computer or a calculator to make the calculation, you shouldn't buy it**." And Charlie Munger added his own slant: "Some of the worst business decisions I've ever seen are those with future projections and discounts back. It seems like the higher mathematics with more false precision should help you, but it doesn't. They teach that in business schools because, well, they've got to do something."

To close on this subject, I want to share a quote I recently came across from Albert Einstein. I've often argued that the key to successful investing lies in subjective judgments made by experienced, insightful professionals, not machinable processes, decision rules and algorithms. I love the way Einstein put it:

> **Not everything that can be counted counts, and not everything that counts can be counted.**

<u>Relying on Ratings</u>

My memos on the reasons for the crisis, like "Whodunit" (February 2008), show that there's more than enough blame to go around and lots of causes to cite. **But if you boil it down, there was one indispensable ingredient in the process that led to trillions of dollars of losses: misplaced trust in credit ratings.** The explanation is simple:

- Competitive pressure for profits caused financial institutions to try to keep up with the leaders. As is normal in good times, the profit leaders were those who used the most leverage.
- Thus institutions sought to maximize their leverage, but the rules required that the greatest leverage be used only with investments rated triple-A.
- A handful of credit rating agencies had been designated by the government as Nationally Recognized Statistical Rating Organizations, despite their highly imperfect track records.
- The people who guard the financial henhouse often have a tough time keeping up with the foxes' innovations. Whereas traditional bond analysis was a relatively

simple matter, derivatives and tiered securitizations were much more complex. This allowed rating agency employees to be manipulated by the investment banks' quantitatively sophisticated and highly compensated financial engineers.

- The rating agencies proved too naïve, inept and/or venal to handle their assigned task.
- Nevertheless, **financial institutions took the ratings at face value, enabling them to pursue the promise of highly superior returns from supposedly riskless, levered-up mortgage instruments. This deal clearly was too good to be true, but the institutions leapt in anyway.**

It all started with those triple-A ratings. For his graduation from college this year, Andrew Marks wrote an insightful thesis on the behavior that gave rise to the credit crisis. I was pleased that he borrowed an idea from "Whodunit": "if it's possible to start with 100 pounds of hamburger and end up selling ten pounds of dog food, 40 pounds of sirloin and 50 pounds of filet mignon, the truth-in-labeling rules can't be working." That's exactly what happened when mortgage-related securities were rated.

Investment banks took piles of residential mortgages – many of them subprime – and turned them into residential mortgage-backed securities (RMBS). The fact that other tranches were subordinated and would lose first allowed the rating agencies to be cajoled into rating a lot of RMBS investment grade. Then RMBS were assembled into collateralized debt obligations, with the same process repeated. In the end, heaps of mortgages – each of which was risky – were turned into CDO debt, more than 90% of which was rated triple-A, meaning it was supposed to be almost risk-free.

John Maynard Keynes said ". . . a speculator is one who runs risks of which he is aware and an investor is one who runs risks of which he is unaware." Speculators who bought the low end of the CDO barrel with their eyes open to the risk suffered total losses on a small part of their capital. But the highly levered, esteemed investing institutions that accepted the higher ratings without questioning the mortgage alchemy lost large amounts of capital, because of the ease with which they'd been able to lever holdings of triple-A and "super-senior" CDOs. Ronald Reagan said of arms treaties, "Trust, then verify." If only financial institutions had done the same.

The rating agencies were diverted from their mission by a business model that made them dependent on security issuers for their revenues. This eliminated their objectivity and co-opted them into the rating-maximization process. Regardless of that happening, however, it's clear that the stability of our financial institutions never should have been allowed to rely so heavily on the competence of a few for-profit (and far-from-perfect) rating agencies. **In the future, when people reviewing the crisis say, "If only they had . . . ," the subject will often be credit ratings. Bottom line: investors must never again abdicate the essential task of assessing risk. It's their number-one job to perform thorough, skeptical analysis.**

The More You Bet . . .

If I had to choose a single phrase to sum up investor attitudes in 2003-07, it would be the old Las Vegas motto: "The more you bet, the more you win when you win." Casino profits ride on getting people to bet more. In the financial markets just before the crisis, players needed no such encouragement. They wanted to bet more, and the availability of leverage helped them do so.

One of the major trends embedded in the chronology on pages two and three was toward increasing the availability of leverage. Now, I've never heard of any of Oaktree's institutional clients buying on margin or taking out a loan to make investments. It might not be considered "normal" for fiduciaries, and tax-exempt investors would have to worry about Unrelated Business Taxable Income.

None of us go out and buy Intel chips, but we've all seen commercials designed to get us to buy products with "Intel inside." In the same way, **investors became increasingly able to buy investment products with leverage inside . . . that is, to participate in levered strategies rather than borrow explicitly to make investments**. Think about these elements from my earlier list of investment developments:

- Investors who would never buy stocks on margin were able to invest in private equity funds that would buy companies on leverage of four times or more.
- The delayed and irregular nature of drawdowns caused people who had earmarked $100 for private investment funds to make commitments totaling $140.
- Options, swaps and futures – in fact, many derivatives – are nothing but ways for investors to access the return on large amounts of assets with little money down.
- Many hedge funds used borrowings or derivatives to access the returns on more assets than their capital would allow them to buy.
- When people wanted to invest $100 in markets with skill-derived return bolted on, "portable alpha" had them invest $90 in hedge funds with perceived alpha and the rest in futures covering $100 worth of the passive market index. This gave them a stake in the performance of $190 of assets for every $100 of capital.

Clearly, each of these techniques exposed investors to the gains or losses on increased amounts of assets. If that's not leverage, what is? In fact, an article entitled "Harvard Endowment Chief Is Earning Degree in Crisis Management" in *The New York Times* of February 21 said of Harvard, "The endowment was squeezed partly because **it had invested more than its assets** . . ." (emphasis added). I find this statement quite remarkable, and yet no one has remarked on it to me.

It shouldn't be surprising that people engaging in these levered strategies made more than others when the market rose. But 2008 showed the flip side of that equation in action. **In the future, investors should consider whether they really want to lever their capital or just invest the amount they have**.

Sharing the Wealth

Apart from the increasing use of leverage, another trend that characterized the five years before the crisis was the widespread imposition of incentive fees.

In the 1960s, at the start of my chronology, only hedge funds commanded incentive fees, and there were too few for most people to know or care about. But fee arrangements that can be simplified as "two-and-twenty" flowered with private equity in the 1980s, distressed debt, opportunistic real estate and venture capital funds in the 1990s, and hedge funds in the 2000s. Soon they were everyplace.

Here are my basic thoughts on this sort of arrangement. (Oaktree receives incentive compensation on roughly half its assets; my objection isn't with regard to the fees themselves, but rather the way they've been applied.)

- **It seems obvious that incentive fees should go only to managers with the skill needed to add enough to returns to more than offset the fees – other than through the mere assumption of incremental risk.** For example, after a high yield bond manager's .50% fee, a 12% gross return becomes 11.5% net. A credit hedge fund charging a 2% management fee and 20% of the profits would have to earn a 16.375% gross return to net 11.5%. That's 36% more return. **How many managers in a given asset class can generate this incremental 36% other than through an increase in risk? A few? Perhaps. The majority? Never.**

- **Thus, incentive fee arrangements should be exceptional, but they're not**. These fees didn't go to just the proven managers (or the ones whose returns came from skill rather than beta); they went to everyone. If you raised your hand in 2003-07 and said "I'm a hedge fund manager," you got a few billion to manage at two-and-twenty, even if you didn't have a record of successfully managing money over periods that included tough times.

- The run-of-the-mill manager's ease of obtaining incentive fees was enhanced each time a top manager capped a fund. As I wrote in "Safety First . . . But Where?" (April 2001), "When the best are closed, the rest will get funded."

- In fact, whereas two-and-twenty was unheard-of in the old days, it became the norm in 2003-07. This enabled a handful of managers with truly outstanding records to demand profit shares ranging up to 50%.

- Clients erred in using the term "alignment of interests" to describe the effect of incentive compensation on their relationships with managers. Allowing managers to share in the upside can bring forth best efforts, but it can also encourage risk bearing instead of risk consciousness. Most managers just don't have enough money to invest in their funds such that loss of it could fully balance their potential fees and upside participation. **Instead of alignment, then, incentive compensation must be viewed**

largely as a "heads we win; tails you lose" arrangement. Clearly, it must be accorded only to the few managers who can be trusted with it.

- **Finally, the responsibility for overpaying doesn't lie with the person who asks for excessive compensation, but rather with the one who pays it.** How many potential LPs ever said, "He may be a great manager, but he's not worth that fee." I think most applied little price discipline, as they were driven by the need to fill asset class allocations and/or the fear that if they said no, they might miss out on a good thing (more on this subject later).

I'm asked all the time nowadays what I expect to happen with investment manager compensation. First, I remind people that what should happen and what will happen are two different things. Then I make my main point: there should be much more differentiation. **Whereas in past years everyone's fees were generous and pretty much the same, the post-2007 period is providing an acid test that will show who helped their clients and who didn't.** Appropriate compensation adjustments should follow.

Managers who actually helped their clients before and during this difficult period – few in number, I think – will deserve to be very well compensated, and their services could be in strong demand. The rest should receive smaller fees or be denied incentive arrangements, and some might turn to other lines of work. Oaktree hopes to be among the former group. We'll see.

Ducking Responsibility

The inputs used by a business to make its products are its costs. The money it receives for its output are its revenues. The difference between revenues and costs are its profits. At the University of Chicago, I was taught that by maximizing profits – that is, maximizing the excess of output over input – a company maximizes its contribution to society. This is among the notions that have been dispelled, exposing the imperfections of the free-market system. (Hold on; I'm not saying it's a bad system, just not perfect.)

When profit maximization is exalted to excess, ethics and responsibility can go into decline, a phenomenon that played a substantial role in getting us where we are. The pursuit of short-term profit can lead to actions that are counterproductive for others, for society and for the long run. For example:

- A money manager's desire to add to assets under management, and thus profits, can lead him to take in all the money he can. But when asset prices and risks are high and prospective returns are low, this clearly isn't good for his clients.
- Selling financial products to anyone who'll buy them, as opposed to those for whom they're right, can put investors at unnecessary risk.
- And cajoling rating agencies into assigning the highest rating to debt backed by questionable collateral can put whole economies in jeopardy, as we've seen.

One of the concepts that governed my early years, but about which I've heard little in recent years, is "fiduciary duty." Fiduciary duty is the obligation to look out for the welfare of others, as opposed to maximizing for yourself. It can be driven by ethics or by fear of legal consequences; either way, it tends to cause caution to be emphasized.

When considering a course of action, we should ask, "Is it right?" Not necessarily the cleverest practice or the most profitable, but the right thing? The people I think of perverting the mortgage securitization process never wondered whether they were getting an appropriate rating, but whether it was the highest possible. Not whether they were doing the right thing for clients or society, but whether they were wringing maximum proceeds out of a pile of mortgage collateral and thus maximizing profits for their employers and bonuses for themselves.

A lot of misdeeds have been blamed on excessive emphasis on short-term results in setting compensation. The more compensation stresses the long run, the more it creates big-picture benefits. Long-term profits do more good – for companies, for business overall and for society – than does short-term self-interest.

Focusing on the Wrong Risk

The more I've thought about it over the last few months, the more I've concluded that investors face two main risks: (1) the risk of losing money and (2) the risk of missing opportunity. Investors can eliminate one or the other, but not both. More commonly, they must consider how to balance the two. How they do so will have a great impact on their results. This is the old dilemma – fear or greed? – that people talk about so much. It's part of the choice between offense and defense that I often stress (see, for example, "What's Your Game Plan?" September 2003).

The problem is that investors often fail to strike an appropriate balance between the two risks. In a pattern that exemplifies the swing of the pendulum from optimistic to pessimistic and back, investors regularly oscillate between extremes at which they consider one to the exclusion of the other, not a mixture of the two.

One of the ways I try to get a sense for what's going on is by imagining the conversations investors are having with each other . . . or with themselves. In 2003-07, with most investors worried only about achieving returns, I think the conversation went like this: "I'd better not make less than my peers. Am I behaving as aggressively as I should? Am I using as much leverage as my competitor? Have I shifted enough from stocks and bonds to alternatives, or am I being an old fogey? If my commitments to private equity are 140% of the amount I actually want to invest, is that enough, or should I do more?"

Few people seemed to worry about losses. Or if they were worried, they played anyway, fearing that if they didn't, they'd be left behind. That must be what drove Citigroup's Chuck Prince when he said, "as long as the music's playing, you've got to get up and dance. We're still dancing." **The implication's clear: No worries; high prices. No risk aversion; no risk premiums**. Certainly that describes the markets in 2003-07.

In the fourth quarter of 2008, when asset prices were collapsing, I imagined a very different conversation from that of 2003-07, with most investors saying, "I don't care if I never make another dollar in the market; I just don't want to lose any more. Get me out!" Attitudes toward the two risks were still unbalanced, but in the opposite direction.

Just as risk premiums disappear when risk is ignored, so can prospective returns soar when risk aversion is excessive. In late 2008, economic fundamentals were terrible; technical conditions consisted of forced selling and an absence of buyers; and market psychology melted down. Risk aversion predominated, and fear of missing out disappeared. These are the conditions under which assets are most likely to be available for purchase at prices way below their fair value. They're also the conditions in which most people go on buying strikes.

In the future, investors should do a better job of balancing the fear of losing money and the fear of missing out. My response is simple: Good luck with that.

<u>Pursuing Maximization</u>

When markets are rising and investors are obsessed with the fear of missing out, the desire is for maximum returns. Here's the inner conversation I imagine: "I need a return of 8% a year. But I'd rather have 10%. 14% would be great, and the possibility of 16% warrants adding to my risk. It's worth using leverage for a shot at 20%, and with twice as much leverage, I might get 24%."

In other words, more is better. And of course it is . . . except that to pursue higher returns, you have to give up something. That something is safety. But in hot times, no one worries about losing money, just missing out. So they try to maximize.

There should be a point at which investors say, "I need 8%, and it would be great if I could get 16%. But to try, I would have to do things that expose me to excessive loss. I'll settle for a safer 10% instead." **I've labeled this concept "good-enough returns**." **It's based on the belief that the possibility of more isn't always better. There should be a point at which investors decline to take more risk in the pursuit of more return, because they're satisfied with the return they expect and would rather achieve that with high confidence than try for more at the risk of falling short (or losing money).**

Most investors will probably say that in 2003-07, they didn't blindly pursue maximization; it was the other guys. But someone did it, and we're living with the consequences. **I like it better when society balances risk and return rather than trying to maximize. Less gain, perhaps, but also less pain.**

*   *   *

"Apropos of nothing," as my mother used to say, I'm going to use the opportunity provided by this memo to discuss market conditions and the outlook. On the plus side:

- We've heard a lot recently about "green shoots": mostly cases where things have stopped getting worse or the rate of decline is slowing. A few areas have shown actual improvement, such as consumer confidence and durable goods orders. It's important when you consider these improvements, however, to bear in mind that when you get deep into a recession, the comparisons are against depressed periods, and thus easier.
- It's heartening to see the capital markets open again, such that banks can recapitalize and borrowers can extend maturities and delever. Noteworthily, Michael Milken and Jonathan Simons wrote in *The Wall Street Journal* of June 20 that, "Global corporations have raised nearly $2 trillion in public and private markets this year . . ."
- Investor opinion regarding markets and the government's actions has grown more positive, and as Bruce Karsh says, "Armageddon is off the table." (He and I both felt 6-9 months ago that a financial system meltdown absolutely couldn't be ruled out.)

These positives are significant, but there also are many unresolved negatives:

- Business is still terrible. Sales trends are poor. Where profits are up, it's often due to cost-cutting, not growth. (Remember, one man's economy measure is another's job loss – not always a plus for the overall picture.)
- Unemployment is still rising, and with incomes shrinking, savings rising as a percentage of shrinking incomes, and credit scarcer, it's hard to see whose spending will power a recovery.
- The outlook for residential and, particularly, commercial real estate remains poor, with implications for further write-offs on the part of the banks. Ditto for credit card receivables.
- Many companies are likely to experience debt refinancing challenges, defaults, bankruptcies and restructurings.
- Developments such as rising interest rates and rising oil prices have the power to impede a recovery.
- Finally, no one can say with confidence what will be the big-picture ramifications of trillions of dollars of federal deficit spending, or the states' fiscal crises.

I'm not predicting that these things will turn out badly, merely citing potential negatives that may not be fully reflected in today's higher asset prices. My greatest concern surrounds the fact that we're in the middle of an unprecedented crisis, brought on by never-seen-before financial behavior, against which novel remedies are being attempted. And yet many people seem confident that a business-as-usual recovery lies ahead. They're applying normal lag times and extrapolating normal decline/recovery relationships. **The words of the late Amos Tversky aptly represent my view: "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."

Peter Bernstein, a towering intellect who sadly passed away a month ago, made some important contributions to the way I think about investing. Perhaps foremost among them was his trenchant observation that, "Risk means more things can happen than will happen." **Investors today may think they know what lies ahead, but they should at least acknowledge that risk is high, the range of possibilities is wider than it was ever thought to be, and there are a few that could be particularly unpleasant.**

Unlike 2003-07 when no one worried about risk, or late 2008 when few investors cared about opportunity, the two seem to be in better balance given the revival of risk taking this year. Thus the markets have recovered, with most of them up 30% or more from their bottoms (debt in December and stocks in March).

If you and I had spoken six months ago, we might have reflected on the significant stock market rallies that occurred during the decade-long Great Depression, including a 67% gain in the Dow in 1933. How uncalled-for those rallies appear in retrospect. But now we've had one of our own.

Clearly, improved psychology and risk tolerance have played a big part in the recent rally. These things have strengthened even as economic fundamentals haven't, and that could be worrisome. (On June 23, talking about general resilience – not investor attitudes – President Obama said the American people ". . .are still more optimistic than the facts alone would justify.") On the other hand, there's good reason to believe that at their lows, security prices had understated the merits. So are prices ahead of fundamentals today, or have they merely recovered from "too low" to "in balance"? There's no way to know for sure.

Unlike the fourth quarter of last year – when assets were depressed by terrible fundamentals, technicals and psychology – they're no longer at giveaway prices. Neither are they clearly overvalued. Maybe we should say "closer to fair."

With price and value in reasonable balance, the course of security prices will largely be determined by future economic developments that defy prediction. Thus I find it hard to be highly opinionated at this juncture. Few things are compelling sells here, but I wouldn't be a pedal-to-the-metal buyer either. On balance, I think better buying opportunities lie ahead.

July 8, 2009

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Memo to: Oaktree Clients

From: Howard Marks

Re: Touchstones

In the two-plus years since the onset of the financial crisis, it's been a regular theme of mine that we should look back, identify the causes and learn from them. I've tackled this assignment in a number of memos and a variety of ways. Now, despite the fact that you've heard much of this from me before, I'm going to try to pull it all together, using the quotations, adages and images that I feel best capture the essence of what we've been through. When I think back, these are the ones that stand out.

<u>"Greed Is Good"</u>

There's no debating which line from the film *Wall Street* is the most memorable. It's hard to forget the image of slicked-back takeover artist Gordon Gekko urging on his troops, invoking the positive power of self-interest. What he meant by "greed is good," of course, was that greed – or self-interest, or the profit motive – is what drives people and companies operating in a free-market setting to strive for more and better, and thus to work hard and optimally allocate resources. It's the force that motivates Adam Smith's "invisible hand" and carries economies to increased output and higher standards of living.

Among the many pendulum-like phenomena we occasionally witness is the swing in people's willingness to rely on the free market. First they trust the market to come up with solutions. Then the shortcomings of those solutions are laid bare and there's a call for regulation. Then the folly of government involvement becomes evident and people want the free market back, and so forth. Because neither extreme is perfect, the oscillation between them goes on. Governments can't run economies or companies. But it's equally true that in a free market, the rules will occasionally be stretched and participants harmed.

In a free market, things will inevitably go past the optimal to the extreme. When they swing back, the retreat can be painful. **Thus, if we're going to rely on the market to settle things, we have to be willing to accept the consequences.**

In the pre-crisis years, the free market was revered and deferred to, and regulation was thought of as little more than a potential impediment to the market's processes. (An article I can't locate in my pile of clippings beautifully explained the dearth of government action: "That's the kind of regulation you get from an administration that doesn't believe in regulation.") That attitude permitted financial institutions to take actions and bear risks that turned out to be unwise, unprofitable and unsustainable. Their strategies took them to the brink of disaster in 2008.

In a truly free market, Bear Stearns, Merrill Lynch, Citibank, AIG, Fannie Mae, Freddie Mac and others likely would have gone bankrupt. Those bankruptcies would have been quite instructive, but also quite painful. If the world is unwilling to live with such lessons from time to time – and if some institutions are considered to be "too big to fail" for society's purposes – then free markets and self-interest have to be restrained. **Greed may be good, but it can be permitted to run free only up to a point.**

Nothing's More Risky Than a Widespread Belief That There's No Risk

The recent crisis came about primarily because investors partook of novel, complex and dangerous things, in greater amounts than ever before. They took on too much leverage and committed too much capital to illiquid investments. **Why did they do these things? It all happened because investors believed too much, worried too little, and thus took too much risk. In short, they believed they were living in a low-risk world.**

In 2006 and early 2007, for instance, we heard a lot about the "wall of liquidity" that was coming toward us from China and the oil producing countries, a flow that could be counted on to provide capital and raise asset prices non-stop. Likewise, we were told (a) the Fed had tamed the business cycle through its adroit management, (b) securitization, tranching and disintermediation had reduced risk by putting it where it could best be handled, and (c) the "Greenspan put" could always be counted on to bail out investors who made mistakes. These and other things were said to have lowered the risk level worldwide.

Belief that risk has been banished is a key element in allowing people to engage in practices they would otherwise view as risky, and in permitting assets to be bid up to prices that would clearly be too high in a world perceived to involve risk.

> . . . former Fed Chairman Paul A. Volcker noted that one of the causes of the financial crisis "was the ultimately explosive combination of compensation practices that provided enormous incentives to take risks" just as new financial innovations "seemed to offer assurance – falsely, as it turned out – that those risks had been diffused." (*The Wall Street Journal*, September 18, 2009)

Worry and its relatives, distrust, skepticism and risk aversion, are essential ingredients in a safe financial system. To paraphrase a saying about the usefulness of bankruptcy, fear of loss is to capitalism as fear of hell is to Catholicism. Worry keeps risky loans from being made, companies from taking on more debt than they can service, portfolios from becoming overly concentrated, and unproven schemes from turning into popular manias. When worry and risk aversion are present as they should be, investors will question, investigate and act prudently. Risky investments either won't be undertaken or will be required to provide adequate compensation in terms of anticipated return.

But only when investors are sufficiently risk averse will markets offer adequate risk premiums. When worry is in short supply, risky borrowers and questionable schemes will have easy access to capital, and the financial system will become precarious. Too much money will chase the risky and the new, driving up asset prices and driving down prospective returns and safety.

> For a market to function, those who invest and lend in that market must believe that their money is actually at risk. (President Obama, September 14, 2009)

Clearly, in the months and years leading up to the crisis, few participants worried as much as they're supposed to.

Soros's Theory of Reflexivity

Some of the biggest problems arise because market participants think of their environment as a static arena in which they act. What they miss – to their frequent detriment – is that their actions alter the environment, causing the results to differ from their expectations.

George Soros has written and spoken most articulately about the ability of investors' actions to change the environment. He calls this process "reflexivity."

> The generally accepted theory is that financial markets tend towards equilibrium, and on the whole, discount the future correctly. I operate using a different theory, according to which financial markets cannot possibly discount the future correctly because they do not merely discount the future; they help to shape it. In certain circumstances, financial markets can affect the so-called fundamentals which they are supposed to reflect. When that happens, markets enter into a state of dynamic disequilibrium and behave quite differently from what would be considered normal by the theory of efficient markets. Such boom/bust sequences do not arise very often, but when they do, they can be very disruptive, exactly because they affect the fundamentals of the economy. . . . (George Soros, MIT Department of Economics World Economy Laboratory Conference, Washington, D.C., April 26, 1994)

My son Andrew, now starting his investment career, has provided an illustration of reflexivity at work that's clear and topical. For several years prior to the crisis, the desire for high returns with low risk (what else is new?) created strong demand for mortgage-based investment products such as RMBS and CDOs. Underpinning it all was the fact that there had never been a nationwide decline in home prices, and thus participants were confident that geographic diversification would render levered mortgage pools safe, warranting triple-A ratings for most of the resulting securities. Rising demand for these products required an increasing volume of underlying mortgages. This need caused lending standards to be weakened and loans to be provided to home buyers with dubious creditworthiness. Easy financing allowed buyers to bid up home prices to levels that exceeded the homes' realistic values and made it tough for borrowers to make their mortgage payments. When the perpetual-motion machine of house appreciation ground to a halt in 2007, the combination of too-high prices and record mortgage defaults resulted in the first nationwide decline in home prices. **Thus, in the end, the belief that an asset was safe led to investor behavior that made it unsafe. That's reflexivity.**

In 2003-07, as described above, investors considered the world a low-risk place. Thus they rushed to buy assets they found attractive, borrowing in order to buy more when their own capital was exhausted. They expected purchases made with cheap leverage to produce high

profits with low risk. But their buying drove up both the cost of the assets and the riskiness of the environment, transforming their "low-risk" strategies into high-risk ones. The consequences have become clear.

Greenspan and Bubbles

One of the most obvious ways in which investors change the environment is through the creation of asset bubbles, like the one that popped in the summer of 2007. In a process that invariably looks silly after the fact, they reach the conclusion that an investment is a sure winner, usually on the basis of simplistic platitudes that simply can't hold up under scrutiny. These include "Internet stocks must rise because these companies are going to change the world," "real estate (or gold) is a good hedge against inflation," "home prices can never decline nationwide," "oil will appreciate because it's being consumed faster than it's being found," and "alternative investments (or hedge funds or private equity funds) hold the key to meeting investment goals."

Because of the strength attributed to these platitudes, investors go on to conclude that the investments they support will be profitable regardless of the price at which they're undertaken. How can this be right? **It's not possible that something can be a good investment regardless of the price paid. But when a logical-seeming platitude is adopted by the stampeding herd, that belief is the result.** That's how we get bubbles.

Bubble thinking is irrational, given that it's built on a belief that there's no price too high. This goes on to manifest itself in a variety of ways. In the 1970s, when hyper-inflation was rampant and interest rates were astronomical, people concluded that no matter the interest rate paid, borrowing to buy "inflation protected" assets like real estate would be profitable. That's bubble thinking.

In my forty-year career, I've seen bubbles in growth stocks, small stocks, oil stocks, emerging market stocks and tech stocks, as well as such surefire winners as silver, homes and buyouts. In each instance, there was a logical underlying rationale for the desirability of the subject assets, but people overlooked the possibility that bubble thinking had raised prices to dangerous levels.

Alan Greenspan greatly influenced economic and market developments during his term as Fed Chairman from 1987 to 2006, and his record on the subject of bubbles was poor. He set the world on its ear in 1996 by railing against "irrational exuberance" as the Dow Jones Index soared past the 6,000 level, but he was quiet thereafter, rationalizing appreciation well beyond 10,000 based on gains in productivity. Here's his position on bubbles:

> . . . bubbles generally are perceptible only after the fact. To spot a bubble in advance requires a judgment that hundreds of thousands of informed investors have it all wrong. While bubbles that burst are scarcely benign, the consequences need not be catastrophic for the economy. (June 17, 1999)
>
> . . . it was far from obvious that bubbles, even if identified early, could be preempted short of the central bank inducing a substantial contraction in economic

> activity – the very outcome we would be seeking to avoid. Prolonged periods of expansion promote a greater rational willingness to take risks, a pattern very difficult to avert by a modest tightening of monetary policy . . . we recognized that, despite our suspicions, it was very difficult to definitively identify a bubble until after the fact. . . . the idea that the collapse of a bubble can be softened by pricking it in advance is almost surely an illusion. (August 30, 2002)

Thus it was his view that (a) bubbles can only be detected in retrospect, not as they occur, (b) even if detected, bubbles are hard to deflate benignly, (c) rather than deflate them, bubbles can be managed, and (d) deflating bubbles isn't the job of the Fed. This relaxed position on bubbles can easily be seen as having abetted their growth. For example:

> . . . testimony before Congress last week refutes, once and for all, the existence of an alleged housing market "bubble," said chief economists of the National Association of Home Builders. . . . "The time has come to put this issue to rest," said NAHB Chief Economist David Seiders. "The nation's home builders have said it, the Realtors have said it, and **now Alan Greenspan has said it once again, in no uncertain terms: there is no such thing as a current or impending house price bubble**."
>
> Asked about the issue during his testimony, Greenspan said, "We've looked at the bubble question and we've concluded that it is most unlikely." He attributed recent "sizeable gains" in home prices to "the effects on demand of low mortgage rates, immigration and shortages of buildable land." (*Business Wire*, July 22, 2002, emphasis added)

Ignoring bubbles is a special case of ignoring risk in general. The philosopher George Santayana is famous for having said, "Those who cannot remember the past are condemned to repeat it." Likewise, **those who fail to learn from past bubbles are bound to suffer in the bursting of new ones.**

<u>The More You Bet, the More You Win When You Win</u>

In the years just prior to the crash, obliviousness to risk encouraged numerous forms of risky behavior. One of the greatest was the use of leverage to increase returns, a phenomenon that became widespread.

People make investments on the basis of positive expected returns. When the cost of borrowing is below the expected return, using leverage appears certain to magnify the gain. Thus the Las Vegas maxim that heads this section comes into play, and it's that kind of thinking that gives leverage its seductive power.

But there's so much more to leverage than that, and unfortunately the rest is learned only when things go badly. Leverage doesn't make an investment better; it merely magnifies the gains and losses. Leverage is what James Grant of *Grant's Interest Rate Observer* calls "money of the mind," meaning it can vanish if the lender is able to take his money back. And any combination of fundamental difficulty, falling asset prices, reduced market liquidity, collateral value tests and margin calls can be the ruination of investors employing leverage. That's what befell many in the fourth quarter of 2008.

In 2003-07, interest rates brought low by the Fed, modest demands for risk premiums on the part of unworried investors, and financial institutions' competition to lend conspired to make low-cost leverage readily available. That cheap financing (a) convinced people that high leverage was the route to increased returns (even from low-yielding underlying investments), (b) armed all parties for a bidding war for assets, and (c) made people rush to borrow and buy before the river of financing ran dry. The result was a buying spree of massive proportions, the bill for which – in terms of debt maturities, often unpayable – will come due in the next few years.

Like just about everything else in investing, leverage is neither good nor bad per se. Used at the right time, in judicious amounts, to purchase low-priced assets, it's a good thing. But that's not the story of the pre-crisis years. And that's a big reason for the trouble we've had since.

<u>"Risk Means More Things Can Happen Than Will Happen"</u>

The above quote from Elroy Dimson of the London Business School helps bring risk into focus. Risk has been the subject of excessive complication and sophistication, but Dimson's simple formulation makes clear what it's all about.

Investing consists entirely of dealing with the future. To do that, people must form opinions about what lies ahead. But few things are more potentially harmful than projections. I've collected a lot of quotations on this subject. Here are my two favorites, but I have a million more:

> We have two classes of forecasters: Those who don't know – and those who don't know they don't know.
>
> John Kenneth Galbraith

> 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.
>
> Amos Tversky

One of the errors committed in 2003-07 – forming a cornerstone of the crisis – consisted of believing too much in the ability to predict the future. Investors, risk managers, financial institution executives, rating agencies and regulators trusted forecasts, extrapolations and computer models. **This made them comfortable with risk, always a dangerous arrangement.**

The "I know" school of investing has received frequent mention in my memos (e.g., "Us and Them," May 7, 2004). Its members – money managers, Wall Street strategists and media pundits – believe that there's a single future, it is knowable in advance, and they're among the people who know it. They're eager to tell you what the future holds, and equally willing to overlook the inaccuracy of their past predictions. **What they repeatedly ignore is the fact that (a) the future possibilities cover a broad range, (b) some of them – the "black swans" – can't even be imagined in advance, and (c) even if it's possible to know which one outcome is the most likely, the others have a substantial combined probability of occurring instead.**

Thus one key question each investor has to answer is whether he views the future as knowable or unknowable. An investor who feels he knows what the future holds will act assertively: making directional bets, concentrating positions, levering holdings and counting on future growth – in other words, doing things that in the absence of foreknowledge would increase risk. On the other hand, someone who feels he doesn't know what the future holds will act quite differently: diversifying, hedging, levering less (or not at all), emphasizing value today over growth tomorrow, staying high in the capital structure, and generally girding for a variety of possible outcomes.

The first group of investors did much better in the years leading up to the crash. But the second group was better prepared when the crash unfolded, and they had more capital available (and more-intact psyches) with which to profit from purchases made at its nadir.

<u>Never Forget the 6'-Tall Man Who Drowned Crossing the Stream That Was 5' Deep on Average</u>

The range of possibilities – the environments with which we must deal – invariably will include some bad ones. We must prepare for them, and the unavoidable prerequisite for doing so is being aware of them. Following from the section above, **the key is to view the future as a range of possibilities, not a reliable point estimate**.

How does the successful investor prepare for the uncertain future? By building in what Warren Buffett calls "margin for error" or "margin of safety." It's having this margin that enables us to do okay even when things don't go our way.

If an investor prepares for a single future and attempts to maximize under the assumption that his view will prove right, he'll be in big trouble if it doesn't. The investor who backs off from the maximizing position is likely to do better when negative surprises occur. Thus it's essential to realize a few things:

- It's not sufficient to think about surviving "on average" – investment survival has to be achieved every day, under all circumstances.
- The ability to survive under adverse conditions comes from a portfolio's margin for error.
- **Ensuring sufficient margin for error and attempting to maximize returns are incompatible**.

The use of leverage illustrates a special case of the above. Leverage increases the gains if you succeed and the losses if you fail. Thus leverage increases the probability of maximizing under favorable outcomes and reduces your margin of safety under unfavorable ones. In 2008, leveraged loans that ultimately proved to be money-good declined in price for psychological and technical reasons. **Loan investors who were able to hold on recovered, but many who had bought with leverage couldn't do so. They drowned in the deep part of the stream.**

<u>Chuck Prince on Dancing</u>

A quotation from the former CEO of Citigroup contains just 30 words, but it could serve as a case study regarding the events leading up to the crash:

> When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing. (Charles Prince, July 9, 2007)

I suspected in mid-2007 that this quotation would end up being emblematic of the cycle. It's been replayed many times, but usually without the first dozen words. Prince seems to have been more aware of what was going on than people give him credit for. He may have sensed the bank was on thin ice in lending and levering, like the rest. The problem wasn't that he overlooked the danger; the problem was that he felt he had to participate anyway.

One of the dilemmas faced by businesses is that they can conclude that they have no choice but to take part in dangerous behavior. Usually this is because they're unwilling to cede market share. On October 5, Leo Strine, Vice Chancellor of the Delaware Court of Chancery, wrote as follows in *The New York Times Dealbook*:

> . . . the ability of any particular firm to resist imitating the overly risky, but law-compliant behavior of competitors will be compromised to the extent that managers face criticism or even removal for not keeping up with so-called industry leaders whose high, short-term returns have pleased a stock market filled with short-term investors looking for alpha.

In "The Race to the Bottom" (February 14, 2007), I described the dangerous behavior that providers of capital engage in when the competition becomes heated. The formula is one of the simplest: **when there's too much money chasing too few deals, asset prices are driven up, prospective returns are driven down, and risk rises**.

Those seven little words – too much money chasing too few deals – represent an absolute death knell for the availability of good returns earned with safety. It should be possible to know when this is the case, as Prince did, but people tend to join in nevertheless. Often this is true because, even if they recognize the danger, they're also aware that "being too far ahead of your time is indistinguishable from being wrong," and they don't want to be out of step.

The way I see it, investors face two main risks: the risk of losing money and the risk of missing out. Although investors should balance the two, in reality this is yet another of those arcs along which the pendulum swings regularly between extremes.

The disposition of a market – the position of the pendulum – can be inferred from the behavior of participants regarding these two risks. In the years just before the crash, encouraged by the purported risk-reducers described on page 2 above, investors generally ignored the risk of loss. In those heady times, they feared only missing opportunities, looking too conservative, and losing business. This combination spurred them to employ aggressive strategies, innovative products, leverage and illiquidity. **When most people think the worst imaginable outcome is failing to participate fully in gains, the result is risky behavior. They're inevitably reminded that there's worse, but it can take a long time to happen.**

"It's Only When the Tide Goes Out That You Find Out Who's Been Swimming Naked"

When I came across the above quotation from Warren Buffett, I borrowed it for "It's All Good" (July 16, 2007) and later devoted an entire memo to it ("The Tide Goes Out," March 18, 2008). Buffett's way of saying things combines brevity, humor and pinpoint accuracy, and this is a great example.

Financial innovation was a major component in building the base for the crisis. As I've said before, **popularization of new investment products is possible only in rising markets, with their suspension of skepticism, easy access to money, and dearth of trying moments. On the other hand, innovations are only tested in falling markets, and few pass the ultimate test.** Californians' homes may contain construction flaws, but we only learn about them during earthquakes. Likewise, a fatally flawed investment product can easily survive until it's tested in a bear market.

The extensive investment innovation of 2003-07 was driven by the poor performance of stocks in 2000-02 and the low yields available on high grade bonds. A large number of new products and strategies emerged, increasing in popularity in a salutary environment. Few investors were troubled by the products' dependence on high leverage or suddenly commonplace triple-A ratings, or by the fact that they hadn't been tested in tough times.

It's not surprising that bull market developments were defrocked in the tougher times of 2007-08, but it's somewhat shocking how many examples there are. It turned out that:

- losses on investments involving leverage, illiquidity or risky assets could be much worse than the "worst case" that had been predicted,
- beta had been confused for alpha, just as leverage had for value added,
- there was nothing absolute about "absolute return," and "market neutral" strategies were correlated with the market,
- the "golden age of private equity" had been a function of easy money, not bargain purchases,
- sharing the upside with investment managers isn't sufficient to align their interests with those of their clients, and
- things that "should happen" often don't.

While an extreme case, the story of Bernie Madoff presents an apt example of this phenomenon. Madoff's fictitious returns weren't very high, but they were remarkably steady; thus his clients thought of his fund as a high-yielding T-bill. This made it easy for the skilled Ponzi schemer to satisfy the few withdrawal requests with cash from eager new investors. This could have continued *ad infinitum* if not for the market collapse in 2008. Madoff's investors had complete confidence in him, but they couldn't get money they needed from other funds that had put up gates, or they didn't want to sell other investments that, unlike Bernie's, were showing big losses. So Madoff received requests for $7 billion of withdrawals, an amount he simply couldn't raise from new suckers, and his nakedness became apparent.

The Madoff story exemplifies the ability of ill-founded investments to prosper in bull markets, and the role of bear markets in exposing them. **Now that the tide has gone out, many pre-crisis miracles have been exposed as non-value based, overly dependent on prosperity and easy money, pro-cyclical, over-hyped or just plain flawed. Hopefully next time, investors will give more thought to how their bull-market dalliances will fare when the tide goes out.**

<u>The Opposite of a Bubble</u>

On the heels of the lessons regarding the run-up to the crash, the latter part of 2008 provided several lessons about behavior in times of crisis. With the fundamental outlook terrible, psychology depressed and technical conditions featuring a great deal of forced selling, that period represented one of the greatest buying opportunities I've ever seen.

I expressed my view that, having been too optimistic before the crash, people were now taking things too far on the downside. It's not easy to resist emotional excesses at highs and lows, but it's by doing so that the best investment decisions can be made:

> . . . it's improbable events that brought on the credit crisis. Lots of bad things happened that had been considered unlikely (if not impossible), and they happened at the same time, to investors who'd taken on significant leverage. So the easy explanation is that the people who were hurt in the credit crisis hadn't been skeptical – or pessimistic – enough. But that [realization] triggered an epiphany: <u>**Skepticism and pessimism aren't synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive**</u>**.** ("The Limits to Negativism," October 15, 2008)

The swing of the pendulum to one extreme or another is a constant in the investment world: from optimism to pessimism, from credulous to skeptical, from sanguine to panicked, from wide-open capital markets to windows slammed shut, from more buyers than sellers to more sellers than buyers and, consequently, from overpriced to underpriced. Thus I was thrilled when an article by my friend James Grant provided a quotation that beautifully sums up the end result of this process:

> To the English economist Arthur C. Pigou is credited a bon mot that exactly frames the issue. **"The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant."** (*The Wall Street Journal*, September 19, 2009, emphasis added)

Optimism thrives in bubbles. That's what they're built on, with optimism and rising prices reinforcing each other. Likewise, crises are brought on by an extreme turn toward pessimism. Falling prices and pessimism contribute to each other on the way down.

In the years just before the crash, no view was considered too optimistic. There were few skeptics around to point out that a notion might be too good to be true. And then, as Pigou says, the opposite became true post-Lehman Brothers. There was no scenario of which someone wouldn't suggest, "But what if it's worse than that?" Now no idea was considered too negative to be true.

The error is clear. The herd applies optimism at the top and pessimism at the bottom. Thus, to benefit, we must be skeptical of the optimism that thrives at the top, and skeptical of the pessimism that prevails at the bottom.

Pigou makes an excellent additional point. Bubbles usually build gradually over time, the result of a steady accretion of logical basis, favorable developments, high returns being achieved, platitudes taken to extremes, willing suspension of disbelief, rising optimism and the recruitment of new buyers. But when the bubble's faulty underpinnings are exposed, it tends to collapse in a rush. The excess of pessimism does arrive quickly, "born a giant." Or as my partner Sheldon Stone puts it, "the air goes out of the balloon a lot faster than it went in."

A recent report by Ian Kennedy and Richard Riedel of Cambridge Associates, entitled "Behavioral Risk," provides an excellent explanation for this process and describes its effect:

> [During good times,] we suffer from what James Montier characterizes as "the illusion of control: the belief that if things go wrong, we will be able to sort them out." When that illusion is shattered during a selling panic, we don't know where to turn or what to think. . . .
>
> What happens when we humans (and, indeed, other animals) are slammed by shock? Unless trained otherwise, our instincts tell us to retreat, conserve, seek the comparative safety of groups, and search for a path out of danger. These are ancient survival instincts, hard-wired. Slammed by *financial* shock, the same instincts result in heightened risk aversion (gimme cash!), a dramatic foreshortening of our normal investment time horizon, an overwhelming impulse to flee with the herd, a tendency to extrapolate current trends all the way to Armageddon . . .
>
> In times of crisis, when risk aversion spikes, panicked investors tend to stampede for the exits. The temptation to join them is well-nigh irresistible because the whole financial edifice seems to be collapsing. Carefully wrought models are rendered irrelevant overnight, as correlations converge on 1.0, and "fat tail" risk wags the dog. . . .
>
> **When markets are falling, we instinctively feel that risk is rising, and when markets are rising, that risk is ebbing. In the short term, this instinct may be right since markets often run on momentum in the short run. But for long-term investors it is dead wrong**. . . . **As equity markets plummet, investors' risk aversion rises even as the fundamental risk is in fact declining**. (emphasis added)

In other words, our instincts and emotions conspire to make us do the wrong thing at the wrong time: to trust at the top and worry at the bottom, and to think something's riskier at $10 than it was at $100, as if the emotion-fed price decline is correct in suggesting that something's wrong.

<u>Buy Low, Sell High</u>

Of all the adages that bear on the events of this extreme cycle we're living through, the simple one just above – probably the first one any of us learned – is still the most important.

In my early years in this business, people who spent all their time on security selection were told that asset allocation can be more important. I'd like to nominate a third candidate for primacy: countercyclical behavior. Consider any intermediate-term period of 3-5 years or so in which the market pendulum makes a significant swing (and that's about all of them). The period 2004-08 presents a good example. Individual security selection had limited impact on the return from a diversified portfolio. Asset allocation mattered much more, but primarily because it determined your posture with regard to the market's swing. **By far the most pivotal thing is whether your investing was anti-cyclical or pro-cyclical. Did you buy more at the bottom or more at the top? Did you invest defensively at the top and aggressively at the bottom, or vice versa? In other words, did you buy low and sell high, or buy high and sell low?**

The Cambridge study describes the importance of resisting the cycle and acting counter to it. It also outlines the difficulty of doing so, and some of the reasons. But it is the most important thing. Did you participate in the errors of 2004-08 or resist? That's the key.

Resisting – and thereby achieving success as a contrarian – isn't easy. Things combine to make it difficult, including natural herd tendencies and the pain imposed by being out of step, since momentum invariably makes pro-cyclical actions look correct for a while. (That's why it's essential to remember that "being too far ahead of your time is indistinguishable from being wrong.") Given the uncertain nature of the future, and thus the difficulty of being confident your position is the right one – especially as price moves against you – it's challenging to be a lonely contrarian.

A few things that can help, however. First, after even a little time spent in the investment business, everyone should know that the herd is usually wrong at the extremes and pays dearly for its error. Second, some contrarians have records that are very impressive. And third, **an accurate reading of investor mood and behavior – perceptive inference of danger or opportunity based on what others are doing in the market – can give investors a good leg up toward being effective contrarians.**

I say we never know where we're going, but we sure as heck ought to know where we are. The cycle isn't unknowable or unbeatable. Touchstones like those enumerated above are there for everyone to see, but few people take full advantage. The key is to be among those who do.

*   *   *

The philosopher Hannah Arendt wrote:

> . . . no matter how much we may be capable of learning from the past, it will not enable us to know the future. (*The Origins of Totalitarianism*, 1951)

We cannot know what the future holds, and history cannot tell us. But awareness of that limitation is a key lesson in itself. Mastering it increases our likelihood of investment success.

November 10, 2009

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Memo to: Oaktree Clients

From: Howard Marks

Re: Tell Me I'm Wrong

My readers treat me well. They indulge my penchant for dissecting the past, and they send kind messages of encouragement. To repay their generosity, I'm going to venture into something I usually avoid: the future of the U.S. economy.

This memo won't be about the future in general, just the elements I find worrisome. As I see it, every investor is either predominantly a worrier or predominantly a dreamer. I've come clean many times: I'm a worrier. By saying that, I absolve myself of having to describe the whole future. I'm going to cover the negatives, starting with the immediate and ending with the systemic (some of the latter repeats themes from "What Worries Me," August 28, 2008). For the other side of the story, I'd suggest you consult the optimists who seem to be in charge of the markets these days.

The Near Term

One thing is indisputable: the rally in financial markets worldwide has outpaced the fundamentals. At the beginning of 2009, most onlookers expected a generally weak economy and were concerned that the behavior of consumers and banks would remain conservative. They were 100% right, and fundamentals are still tenuous. And yet, the rally has exceeded all expectations of which I'm aware.

Market participants have grasped at slender "green shoots": things that are declining but at a slower rate, or that have stopped getting worse, or that have begun to improve, albeit anemically (e.g., "At some of the nation's largest lenders, the number of consumer loans that are going bad is starting to level off." *The New York Times*, January 21). Most of the good news falls into those categories; little or nothing has blown anyone's socks off. We haven't seen much economic news that's overwhelmingly positive, despite the fact that (a) today's comparisons are against very weak periods a year ago, (b) our exports have been made cheaper by a dollar that's 10-20% lower, and (c) there's been an enormous amount of government stimulus. The gains being reported are often in tenths of a percent, and the other day my drive-time radio commentator said, "Hirings are almost equal to firings." That doesn't tell me we're in the midst of a strong recovery, or on track for one.

In particular, most companies' sales remain quite weak. The economy is generating very little growth at the so-called "top line" on which Gross Domestic Product is based. Rather, the profit gains being reported have been aided in large part by cost cutting. But "cost cutting" and "productivity gains" are nice-sounding ways of saying companies are getting by with less labor. Thus the employer's productivity gain can be the employee's job loss. It doesn't bode well for the general welfare, consumer spending or GDP growth if the level of business activity, as seen in revenues, isn't rising; GDP doesn't benefit from profit margin expansion.

Reliance on Government Stimulus

A year or so ago, the government came to the rescue of the economy with massive stimulus. With the Great Depression as a reference point, Bernanke et al. were determined to limit the contraction in liquidity, support financial institutions and encourage economic activity. Some say too much has been spent, the resulting deficits are worrisome, and the program's a flop, since the economy's still languishing and unemployment remains high.

But the fact that growth is sluggish doesn't mean the stimulus has failed. The relevant question isn't how the economy is doing, but how growth compares against what it would have been without the stimulus. "What if" questions like that are largely unanswerable, but I'm sure we're much better off than we would have been without the government's help.

Home sales are weak, but what would they be if the federal government wasn't directly or indirectly backing 80-85% of all new mortgages and providing $8,000 tax credits to first-time home buyers? What would 2009 auto sales have been without the "cash for clunkers" program? GDP growth is insubstantial, but what would it be if government spending hadn't risen by double digits?

Although not all the money has been well spent – "a blunt and messy solution" according to William Dudley, president of the New York Federal Reserve (*The New York Times*, January 21) – it seems clear the stimulus program has prevented a much more dire outcome. Regardless, the economy's response is tepid, and I wonder whether the slow growth reflects negative underlying secular trends. This makes me tend toward an expectation that the recovery will be lackluster, and that it will take years before we get back to anything approaching the vibrancy of the period preceding the crisis.

I fall back on the analogy of a stalled car (the economy) being pulled by a tow truck (government stimulus). The tow truck will want to let the car down one of these days and go on its way. Will the car be able to move on its own? We can only wait and see. I think it's more likely to sputter along than it is to move forward energetically. But at least we don't have to worry any longer about the analogy of fifteen months ago: an airplane whose engine has flamed out. A powerless plane in mid-flight presents a far more troubling image than a stalled car.

The Role of Interest Rates

Interest rate reduction has played an extremely important part in the government's efforts to end the crisis and bring the economy back to life.

- By reducing short-term interest rates (in this case to near-zero), the government makes it more attractive to spend and invest, stimulating the economy. This is the most direct effect.

- Lower rates also provide a direct subsidy to financial institutions, which can borrow cheaply and lend at higher rates. (If a bank can borrow $100 from the government at 1% and lend it out at 6%, it's as if the government wrote the bank a check for $5 – but more subtle and perhaps less vexing to Main Street, and with potentially positive multiplier effects.) Given the state of financial institutions in 2008, it's clear this element was essential.

- There's a third, less direct effect. Rock-bottom rates on Treasurys push people to chase high returns by undertaking riskier investments. A year ago, the pensioner living on interest opened his year-end mutual fund statement and saw that the return on his T-bill or money market fund was close to zero. He grabbed the phone and called the company to say, "Get me out of that fund and into the one that's paying 15%" . . . and so became a high yield bond investor.

It's clear from the behavior of the markets that something has been goosing investment performance, since the best gains have been seen in the fundamentally riskiest assets. Part of it is general easing of the excessive risk aversion and fear of a year ago, and part is a justified rebound from too-low prices. But certainly near-zero interest rates have played a major part.

As with most remedies – economic and otherwise – ultra-low interest rates raise questions:

- Will economic recovery continue if rates go to market levels?
- Will financial institutions remain viable without the subsidy of low rates?
- Can the residential real estate market recover without support from cheap mortgages?

But what if rates remain low?

- Will foreigners continue to lend the U.S. the money it needs to cover its deficits?
- Can the dollar hold its value against other currencies if international demand weakens for dollars with which to invest in the low-yielding U.S.?
- Most market participants tend to extrapolate currency movements (rather than project their reversal). So if low rates cause the dollar to weaken, will non-U.S. investors shy further from our currency to avoid continued weakness, exacerbating these issues?

Global considerations call for higher rates, but fighting domestic economic weakness relies on low rates. Resolving this dilemma won't be easy . . . or painless.

The Importance of Consumer Spending

At two-thirds of GDP, consumer spending was the linchpin of U.S. economic growth in the decade-plus leading up to the credit crisis. And the foundation for the rapid growth in that spending was the availability of consumer credit and the willingness to use it.

The innovation and explosion of consumer credit, which I view as having begun in the 1970s, enabled Americans to spend money they didn't have to buy things they couldn't afford. This was compounded in the current decade by vastly lowered credit standards for first mortgages and by radical expansion of what used to be called second mortgages but were re-labeled "home equity loans." The final element in the equation was the decline in the savings rate to roughly zero in the last decade. Thus consumers spent all they made and, in many cases, more.

These trends enabled growth in spending to exceed the growth in incomes, adding substantially to the growth in GDP. Few people seemed to understand that increases in home prices weren't inexorable, or that there was anything wrong with incurring debts without a foreseeable way to repay them. Shopping became a national pursuit, and fads like "investment dressing" and "investing in collectibles" made reckless spending seem rational.

This all fell apart when the uptrend in home prices collapsed and consumer credit and home loans became unavailable. Fear suddenly replaced limitless optimism among consumers, shopping became dispensable, and the savings rate rebounded to around 5% – meaning spending suddenly grew slower than incomes (which themselves were contracting). The trend in consumer spending, which had buoyed the economy, now led its decline. Further, businesses saw no reason to expand inventories or factory capacity, transferring the slowdown to the manufacturing sector.

What will happen in the future? Will spending rebound? Or will the swing toward frugality and savings be permanent? I recently read an article which dismissed the latter possibility, saying, "People still want a better life." **I don't doubt that, but what if that "better life" comes to be defined as having more savings and less debt, rather than a new car or another handbag?**

According to *The Wall Street Journal* of December 17:

> . . . businesses ranging from shoemakers to financial services to luxury hotels don't expect American consumers to return to their spendthrift ways anytime soon. They see consumers emerging from the punishing downturn with a new mindset: careful, practical, more socially conscious and embarrassed by flashy shows of wealth.

Prudence dictates that people should have savings. But I hasten to point out that "should" isn't the same as "will." There's a maxim that "No one ever went broke underestimating the intelligence of the American consumer." I'd prefer to see consumers save rather than return to over-spending – it's healthier for families and for the economy in the long run, providing reserves in case of emergency and capital for investment. But I won't be shocked if they don't.

<u>The Outlook for Real Estate</u>

Just as happened in homes, commercial real estate saw an explosion of excesses in the years leading up to the crisis. Investors and funds – perhaps pursuing the myth that real estate is a good inflation hedge regardless of the price paid – were aggressive buyers.

Capitalization rates or "cap rates" (the demanded ratio of net operating income to price) fell to 4% and sometimes less, implying price/earnings ratios of 25 or more. Property buyers applied those ratios to peak operating income and financed their purchases with copious amounts of debt.

Right now, most borrowers are avoiding default, sometimes abetted by lenders practicing "pretend and extend." What they're pretending is that commercial real estate loans will be repayable upon maturity.

It seems inescapable that over the next few years:

- higher vacancy rates and lower rents will keep net operating income from returning to the peak levels of the last cycle,
- property buyers won't go back to finding sufficient risk compensation in pre-crisis cap rates, and
- financial institutions aren't going to lend the same high percentage of property purchase prices as they did 3-4 years ago.

Any one of these factors would make it hard for commercial real estate to again command its pre-crisis prices, or for it to be financeable or refinanceable at those levels. Together, the three elements mean many properties are "upside-down" today. That is, their market value is less than the debt against them.

Will a $100 million loan secured by an $80 million building be repaid or refinanced? Unlikely. And since that description covers a great deal of commercial real estate today, many real estate loans will go unpaid at maturity. That implies widespread losses for investors and write-downs for lenders.

Many small and medium-sized banks have too much local real estate and construction loans in their portfolios. They fell for the myth of safety in real estate and forgot about the need for geographic diversification. Thus, in addition to real estate bankruptcies, the next few years may see numerous small bank failures.

<u>State and Local Governments</u>

I'm surprised how little we read today about municipal finances. In addition to regularly spending more than they took in (thanks to the miracle of borrowing), many state and local governments got into the habit of ratcheting up budgets in good times, establishing or expanding irreversible spending programs. Thus, today's substantial declines in sales, income and property tax revenues can't be met with corresponding cuts in spending.

So now we have massive deficits in places like New York and California – the result of strong spending at a time of soft income. The situation in the latter, my home state, is further complicated by (a) the ability of voters to enact new spending programs through referendums without having to worry about where the money will come from, (b) the fact that the most famous referendum of them all – Proposition 13 – essentially prevents homes from being reassessed to reflect appreciation and (c) the requirement that the annual budget be approved by two-thirds of the legislators in each house, virtually ruling out any unpleasant medicine. It's for that reason that California resorted to paying its bills in scrip (a practice since discontinued) and furloughing state employees.

Will states and cities go bankrupt in coming years? What will be the effect on their bondholders, and on the municipal bond market as a whole? How will bankruptcy be reconciled with municipal bond issuers' promises to dedicate their full faith and credit to paying interest and principal (and thus, implicitly, to raise taxes without limitation)? How will the federal government respond? If it opens its coffers to bail out profligate states, what will that say to states that were prudent enough to stay out of trouble? No answers here, but lots of trouble in sight.

Our Dance with China

Here are the facts:

- China has vast resources, human and otherwise.
- It produces goods cheaper than the developed countries.
- China's likely undervalued currency aids its competitiveness as an exporter.
- The U.S. buys more from China than it sells to China.
- That means dollars keep piling up in China.
- The U.S. has to borrow back those dollars to fund its fiscal and trade deficits.
- We'd prefer low interest rates in order to minimize our interest payments, and a weak dollar so we can repay our debts (as if!) in devalued currency.
- China, with its reserves growing, has to invest large amounts of dollars.
- China wants high rates and a strong dollar in order to maximize the value of our future payments to them.
- China would probably like to diversify the investment of its reserves away from the dollar, but (a) it's hard to figure out where to better invest them and (b) doing so would further weaken the dollar, of which China already owns so many.

The great thing about not being an economist is that I don't have a view on how all of this will play out. But I'm sure it implies considerable uncertainty.

Wherefore Jobs?

I wonder what will occupy the millions of Americans dependent until now on "physical" jobs. In the late nineteenth century, agriculture became mechanized and many people left the South to find manufacturing jobs in the Midwest. Then manufacturing was automated over time, and the economy went global, reducing the need for American factory workers. Today, relatively little manufacturing takes place in the high-cost U.S. Increasing percentages of our jobs are now in services, government, healthcare, retailing, intellectual property and information.

In "What Worries Me," I expressed concern about an American economy that manufactures less and less, as well as puzzlement regarding the consequences. Where will jobs come from as the population grows and manufacturing continues to shrink?

> In addition to replacing 7.2 million lost jobs [since the recession began in December 2007], the economy needs an additional 100,000 a month to keep up with population growth. If the job market returns to the rapid pace of the 1990s – adding 1.25 million private-sector jobs a year, double the 2001-2007 pace – the U.S. wouldn't get back to a 5% unemployment rate until late 2017, Rutgers University economist Joseph Seneca estimated. (*The Wall Street Journal*, October 5, 2009)

"We'll give each person a diploma and a laptop" seems to resonate from the last presidential campaign, but I don't see that as much of an answer to the problem since (a) not every strong back can be redirected to a desk job, especially given that our system of public education is in crisis, and (b) one of the advantages of an information economy is supposed to be that it needs fewer workers to get business done.

In short, I worry that the growth in jobs in the recovery will be slow, and that unemployment and underemployment will remain stubbornly at higher levels than in the past. That doesn't bode well for either the short-term cyclical recovery or the long-term outlook.

Global Competitiveness

Now that the world is one big market and consumers have their choice of goods from anywhere in it, success in producing and selling is largely a function of cost competitiveness. For years, things like the superiority of American products blunted foreign competition. One of the results was that the American worker enjoyed the highest wages and standard of living in the world. But now China, Korea and other nations have eclipsed much of our manufacturing advantage, allowing them to produce goods that are not just cheaper but at times better.

It stands to reason that today, goods produced with high-priced inputs will not compete successfully. In order for U.S. goods to be competitive, our costs will have to come down, and with them our relative standard of living. Why should any country's workers be able to command a higher standard of living if the goods they produce aren't demonstrably superior?

These trends have already taken effect in "legacy industries" like airlines and autos. For example, one of the main goals of the auto bankruptcies was to limit retirees' lifetime benefits. I think we'll continue to see declining relative costs in the U.S., to the betterment of our competitiveness but the detriment of our workers.

Inflation, Exchange Rates and Interest Rates

The macro question I get most often concerns the outlook for inflation. And as someone who lived through stagflation in the 1970s and paid interest at 22-¾%, I think it's very much worth considering.

The hyperinflation of the '70s was sparked by the Oil Embargo of 1973. Labor contracts and benefit plans containing cost-of-living adjustments built on that to create a cost-plus cycle in which inflation lifted wages, contributing further to inflation, and so forth. Rising prices frightened people into demand-pull inflation by convincing them to stock up on goods to avoid higher prices later. And people borrowed to invest in assets like land out of a belief that no matter what interest rate they paid to finance their purchase, the asset's price would increase at a faster rate (the epitome of inflationary thinking).

No one knew how to solve the problem. I used to go to hear "Dr. Gloom" and "Dr. Doom" (economists Al Wojnilower of First Boston and Henry Kaufman of Salomon Brothers) compete to be more depressing. They talked about how hard it would be to get inflation down to "an acceptable level." One day, I heard someone ask for the definition of "an acceptable level." He was told "one-third less than whatever it is at the time."

Finally, however, in the early 1980s Paul Volcker and the Fed implemented the painful solution of significantly higher interest rates, inflation subsided, and the stock market took off. Over the next 25 years, rising inflation and interest rates were forgotten as possible sources of risk.

Today, labor in the U.S. lacks the power to demand strong wage increases or COLAs. Further, the sluggish macro picture argues against demand-pull. Strong inflation is usually associated with higher levels of prosperity and stronger demand for goods than I foresee. Finally, inflation often presupposes pricing power on the part of manufacturers, which I also don't see.

Those are the factors that argue against an increase in inflation. However, because of other forces – primarily financial and international – it could take increasing numbers of dollars to buy a given quantity of the imported goods on which we've become so dependent (a.k.a. inflation).

- As I mentioned earlier, debtors want there to be inflation so they can repay their debts with currency that's worth less. To accomplish this, debtor nations have the ability to debase their currencies by printing more of it. For the clearest example, see "The Limits to Negativism" (October 15, 2008) on the subject of the Weimar Republic. Post-World War I Germany was assessed war reparations it couldn't afford, so it simply over-stamped its 1,000 mark notes "1 million marks." All of a sudden it had created enough marks to pay its debt to the world . . . and destroyed the purchasing power of its currency.
- A dollar weakened by reduced demand for it (e.g., as a vehicle for the investment of China's reserves) would, likewise, equate to more dollars per item bought from abroad.
- Finally, "stores of value" like gold hold value only because people agree they will. The same goes for currencies. Profligate spending, runaway deficits and declining world position could reduce the role of the dollar as a reserve currency, again cutting into its purchasing power.

I'm certainly in no position to predict a decline in the purchasing power of the dollar (that is, a bout of strong inflation). However, I do think it's very much worth worrying about.

When Paul Volcker left the Fed in 1987, he was asked at his first public appearance, "Will interest rates go up or down?" He answered presciently: "Yes." Of course, his answer is still the right one. **But from today's levels, I think rates are more likely to go up than down (there's so little room for the latter).**

Reduced faith in the dollar means it would take higher interest rates to attract non-U.S. buyers to dollar investments. And, even domestically, (a) one of these days the government will stop holding rates down and (b) higher inflation would require rates to rise to compensate for the fact that the dollars with which debts are repaid will buy less. For all these reasons, I think investors must consider the prospect of higher inflation, dollar weakness and higher interest rates.

What to do about them? The list of possibilities is long:

- Buy TIPS.
- Buy floating rate debt.
- Buy gold (but only at the "right" price, and what's that?)
- Buy real assets, such as commodities, oil and real estate (ditto).
- Buy foreign currencies.
- Make investments denominated in foreign currencies.
- Buy the securities of companies that will be able to pass on increased costs.
- Buy the securities of companies that own commodities, or that own assets denominated in foreign currencies.
- Buy the securities of companies that earn their profits outside the U.S.
- Hold cash (to invest once interest rates have risen).
- Sell long-term bonds (and possibly go short).

These are the actions that can profit from – or that provide the flexibility to adjust to – increased inflation, a decline in the dollar and increased interest rates, all of which are interconnected. The most important one is the last one: long-term bonds could suffer worst in an inflationary, higher-rate environment, especially given today's low starting yields.

One final point: When I provide this answer to the frequent question about inflation, I ask people whether they agree. Usually they do. Then I ask how much of their portfolio they're willing to devote to protecting against these macro forces. If their answer is 5%, 10% or 15%, I point out that that's pretty close to doing nothing. The question is whether you're willing to devote at least 30-40%. Few people are.

But that's the thing: It's easy to say, "I'm worried about inflation." It's something very different to say, "I'm worried enough about inflation to do something meaningful about it." Let me know when you decide how much you're willing to devote.

<u>The Environment for Business</u>

Moving all the way out on the timescale, I'd like to say a few words about some of my biggest-picture concerns.

I worry about long-term problems that are being left untreated, such as our massive deficits and our under-funded Social Security, Medicare and education systems.

I worry about the long-term impact of government involvement in business decisions: telling companies what they should pay top employees and setting minimums for the percentage of premium revenue that a health insurer should pay out in benefits, for example. The Obama administration has the smallest percentage of Cabinet secretaries with backgrounds in the private sector of any president since Teddy Roosevelt, according to the November 24 issue of *Forbes*. People in the executive and legislative branches with no experience in business are telling business how to operate.

Lastly, I worry about the rising tide of populism and anti-business sentiment. I've never seen negative attitudes like those toward financial institutions today. Administration members with Wall Street backgrounds are regarded with suspicion; high incomes are considered wrongful; and banks and investment banks are seen as victimizing America, not rendering it prosperous. Schadenfreude is in the ascendancy, with people wishing ill for successful bankers. Politicians pander by throwing gasoline on the fire. With an election coming up, I expect candidates to compete to see who can be tougher on Wall Street.

I mentioned in "What Worries Me" that decades ago, when a socialist-leaning labor movement was ascendant in the U.K., I came across a good explanation for the success of U.S. business:

> When the worker in England sees the boss drive out of the factory in his Rolls Royce, he says, "I'd like to put a bomb under that car." When the American worker sees the boss drive out in his Cadillac, he says "I'd like to own a car like that someday."

More recently, in 2005, Thomas Friedman compared old and new economies as follows:

> **French voters are trying to preserve a 35-hour work week in a world where Indian engineers are ready to work a 35-hour day. Good luck. . . .**
>
> Voters in "old Europe" – France, Germany, the Netherlands and Italy – seem to be saying to their leaders: stop the world, we want to get off; while voters in India have been telling their leaders: stop the world and build us a stepstool, we want to get on. . . .
>
> A few weeks ago Franz Müntefering, [then] chairman of Germany's Social Democratic Party, compared private equity firms – which buy up failing businesses, downsize them and then sell them – to a "swarm of locusts."
>
> **The fact that a top German politician has resorted to attacking capitalism to win votes tells you just how explosive the next decade in Western Europe could be,** as some of these aging, inflexible economies – which have grown used to six-week vacations and unemployment insurance that is almost as good as having a job – become more intimately integrated with Eastern Europe, India and China in a flattening world. ("A Race to the Top," *The New York Times*, June 3, 2005 – emphasis added)

Capitalism, free enterprise, pro-business policies, adaptability, work ethic and profit – these are the concepts that have generated most of the material progress in this world.

They were behind much of America's relative gains in the twentieth century, just as they now hold great promise for China, India and Brazil. Compare the growth records and prospects of countries that exhibit them against countries that don't. **Which kind of country will the U.S. of the future be?**

Today people seem to think of companies like Goldman Sachs and JPMorgan Chase as enemies, not friends – companies to be rooted against, not for (and there are non-financial examples as well). I'd like those people to tell me what engine of progress will propel America ahead in the twenty-first century. It's not going to be the barbershops and fast-food outlets. It has to be big, world-leading businesses, working on behalf of their investor-owners.

We're a big country, and we'd better pull for big business – not against it. We'd better remember that "what's good for business is good for America." If we don't, and if big business isn't allowed to thrive, wondering about the shape of the coming recovery or the outlook for security prices in 2010 will amount to nothing more than "rearranging the deck chairs on the Titanic."

Investment performance in a single year should matter principally to people who're going to liquidate their portfolios at the end of that year. Most of us expect our holding periods to go on well beyond 2010. So we'd better hope for a salutary long-term environment in which to hold.

* * *

I'm not writing to be negative or to depress readers. And as I said earlier, I don't claim to be presenting the whole picture. Nevertheless, I hope I'm providing a service.

The question isn't whether there'll be a recovery, but what type. In fact, a recovery is doubtless underway as I write. But for the reasons enumerated above, I think it'll turn out to be anemic and possibly marked by fits and starts, not a powerful "V."

- The recovery will face headwinds in the form of declining manufacturing and weak job creation.
- Slow job growth, sluggish incomes, spending that grows slower than incomes, and scarcer consumer credit likely will combine to limit the consumer's ability to energize the economy.
- Removing the props of elevated government spending, debt guarantees and artificially low interest rates will limit its vibrancy.
- We'll continue to face challenges in terms of real estate losses, bank write-downs and fiscal and trade deficits.

On the other hand, near-term economic statistics will benefit from the following:

- easy comparisons against depressed prior levels,
- the rebuilding of inventories and refilling of pipelines to meet recovering demand, and

- big companies' large cash holdings, delevered balance sheets and eagerness to respond to increased orders.

When people ask me when we'll get back to normal, I ask what they mean by normal. If they mean an environment like 1992-2007, I tell them those were unusually good times, not what the "normal" of the future is going to look like.

The fifteen (or 25) years just prior to the credit crisis were marked by strong, consumer-led growth; rapidly increasing use of credit; American leadership in media, software, technology and financial products; and powerful bullishness and expansiveness. I doubt the years just ahead will be equally positive.

My goal in this memo isn't to express a forecast. I know no forecast – and certainly not mine – is likely to be correct. What I do want to do is caution that the considerable risks I see may be less than fully appreciated by those setting asset prices today. The greatest market risks lie in failure of the macro economy to live up to the expectations embodied in today's prices. **Please tell me if you think I'm wrong in letting the factors described above push me toward caution. In fact, I'd love it if you told me my worries are unfounded, and that our economic and business future will see a complete return to good times.**

Most people view the future as likely to repeat past patterns, which it may or may not do. They tend to think of the future in terms of a single scenario, whereas it really consists of a wide range of possibilities. (Remember Elroy Dimson's trenchant observation that "risk means more things can happen than will happen.") And to the extent they do consider a variety of possibilities, few people include ones that haven't been part of recent experience.

The uncertainties discussed above tell me today's distribution of possibilities has a substantial left-hand (i.e., negative) tail, probably greater than at most times in the past. The proper response should be to discount asset prices, allowing a substantial margin for error. Forecasts should be conservative, yield spreads should incorporate ample risk premiums, valuation parameters should be below the long-term norms, and investor behavior should be prudent.

And yet, the powerful rally of 2009 has more than offset the decline of 2008 in many asset classes. To the extent that the resultant valuations incorporate optimism, I would argue for caution today. A lot of "easy money" was made last year; in retrospect, all you had to do was have access to capital and the guts required to invest it at the absurd low prices of late 2008/early 2009 and hold on during the wild recovery. **Of course, those things were far from easy at the time.**

The profits ahead won't be easy money. They'll require careful selection, appropriately high risk consciousness, insistence on margin for error, and cooperation from the forces that determine outcomes (such as luck). With most assets valued about fairly today, caution, discernment and discipline – not much needed in 2009 – have replaced guts as the essential elements in profitable investing.

January 22, 2010

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Memo to: Oaktree Clients

From: Howard Marks

Re: I'd Rather Be Wrong

Just a few weeks ago, I published "Tell Me I'm Wrong," my latest list of things in the investment environment that I find worth worrying about. I'm going to devote a few pages here – I promise this'll be the shortest memo in years – to a point I touched on in "What Worries Me" (August 28, 2008) but omitted from the more recent piece.

This memo will be about one of the inarguably most depressing topics of our time: the seeming inability of governments and politicians to solve – or even tackle – the financial problems we face. Here's the situation in Washington:

- Many of our most sweeping financial problems, such as deficits, national debt, healthcare costs, Social Security and Medicare, are long-term problems.
- It's important that we tackle them early, since limiting their further growth can reduce the eventual cost and difficulty of fixing them.
- But the process of solving them will be unpleasant in the short term, entailing bad-tasting medicine, while the benefits will only be seen in the long term, when today's politicians will have left the stage.
- Finally, most politicians' main concern seems to be getting themselves and other members of their party elected. Voting for short-term pain in order to solve long-term problems is generally viewed as the wrong way to go about that.

This memo is inspired by two excellent newspaper articles that appeared within the last month: "Party Gridlock Feeds New Fear of a Debt Crisis," by Jackie Calmes (*The New York Times*, February 17)[*] and "Perils of the California Model" by David Wessel (*The Wall Street Journal*, March 4).[†] Indicating their importance, *The Times* piece ran in the upper right-hand corner of the front page, always the place for the top story of the day, and the *Journal* story was carried on page A2. I've included links below in the hope they'll increase your likelihood of reading them. As Calmes wrote in *The Times* (in both cases below, emphasis added):

> After decades of warnings that budget profligacy, escalating health care costs and an aging population would lead to a day of fiscal reckoning, economists and the nation's foreign creditors say that moment is approaching faster than expected, hastened by a deep recession that cost trillions of dollars in foregone tax revenues and higher spending for safety-net programs.
>
> **Yet rarely has the political system seemed more polarized and less able to solve big problems that involve trust, tough choices and little or no short-**

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[*] http://www.nytimes.com/2010/02/17/business/economy/17gridlock.html
[†] http://online.wsj.com/article/SB20001424052748704541304575099371249822654.html

> **term gain.** The main urgency for both parties seems to be about pinning blame on the other, before November's elections, for budget deficits now averaging $1 trillion a year, the largest since World War II relative to the size of the economy.

Two weeks later, Wessel put it this way in *The Journal*:

> The stalemate over health-care legislation, despite widespread acknowledgment that the status quo is unsustainable, underscores the inability of the political system to cope with complex, long-term fiscal issues. . . .
>
> Today, the deficits projected are bigger than ever, baby boomers are beginning to retire, health-care costs keep rising and, surely, we're closer to the day when Asian governments grow reluctant to lend ever-greater sums to the U.S. Treasury at low interest rates.
>
> The Congressional Budget Office projects current policies would take the deficit from today's 10% of gross domestic product to over 20% by 2020 and over 40% by 2080. **Yet today's politics appear more toxic, and the ranks of congressional leaders with the skill and desire to fashion compromises instead of talking points are depleted.**

Here we have remarkably similar themes voiced in what some would call "a Democrat newspaper" and in a stalwart of the pro-business Republican establishment. Both articles complain that the current trends in politics reduce the likelihood that major problems will be tackled and solved . . . a rare example of agreement across the aisle.

That brings me to the subject of one of today's greatest stumbling blocks, the absence of that elusive ideal: bipartisanship. Let's discuss this issue in principle. It's likely that the "ins" always think the fact that voters gave them control means they should mostly get their way, and that "bipartisanship" consists of the "outs" going along with them. The outs, on the other hand, don't take the election results to mean the minority has no rights, and they feel perfectly within their rights to use Congress's rules and processes to fight for their point of view (which, on us-versus-them issues, equates to thwarting the efforts of the ins).

The Times article points out ironically that when control of government is divided between the two parties, they both feel some responsibility for solving problems, while today, with full control seemingly in the hands of the Democrats, the Republicans are free to view their only role as dissenting and obstructing. And as the party in control, the Democrats evidently feel no obligation to yield on their positions.

Frankly, I wouldn't be so unhappy if I were sure today's battles were being fought over principles. What worries me most is the appearance that, instead, they're being fought for personal and political advantage and to win elections.

Today I think few legislators from either party will vote for anything that would let members of the other party claim to have accomplished something. That may be an exaggeration, but I think it's more true than false. And I think that's behind the recent decisions by a number of senior legislators not to run for re-election. I've had the privilege of getting to know Byron

Dorgan, the senator from North Dakota, and I have no trouble believing that was behind his decision. We've spoken about his frustration with the contentious environment in Washington. More recently, Evan Bayh of Indiana also said he wouldn't seek another term in the Senate because it's impossible to get anything done in dysfunctional Washington. Here's how he put it in a February 21 Op-Ed piece in *The Times*:

> There are many causes for the dysfunction: strident partisanship, unyielding ideology, a corrosive system of campaign financing, gerrymandering of House districts, endless filibusters, holds on executive appointees in the Senate, dwindling social interaction between senators of opposing parties and a caucus system that promotes party unity at the expense of bipartisan consensus.

Today's positions seem unusually unyielding. The Republicans' conservative base demands adherence to the no-tax pledge, while liberal Democrats demand that their representatives prevent cuts in spending for domestic programs. These hardened (and polar) positions greatly narrow the possible grounds for problem-solving.

When the seller says "I won't accept any price below $20" and the buyer says "I'll never pay more than $18," no deal can be struck, whereas in more flexible times they might meet at $19. Maybe one party or the other (or both) is right and should stand on principle. But when we need them to find common ground on which to solve critical problems, refusal to reach agreement isn't to our advantage.

- Everyone wants to see the deficit narrowed, but today's circumstances seem to prohibit both expenditure reduction and revenue increases. Everything else is on the table (as the kids say, lol).

- We know Social Security has to be fixed in order to prevent its inevitable insolvency, since there are fewer and fewer working people paying into the system per retiree. However, some people find it unacceptable to raise tax rates or the limit on taxed income, and others resist reducing or delaying benefits. Thus no one in Washington seems to prefer tackling the problem over sweeping it under the rug (Congress's version of "extend and pretend").

- On the state and local level, there's massive underfunding of pensions, but few officials consider it possible to either reduce benefits or increase employee/employer contributions. Thus only two possibilities remain: ignore the problem or hide it by increasing the assumed return on assets (from today's already-challenging levels of 8% or more).

In the old days, the Lyndon Johnsons in Congress would sit down for a drink with the other side, swap a "yes" vote on this for something else, and get things done. For any of a million reasons, this seems impossible today. Calmes quotes G. William Hoagland, a former fiscal policy adviser to Senate Republicans, as follows:

> I used to think it would take a global fiscal crisis to get both parties to the table, but we just had one. These days I wonder if this country is even governable.

I hasten to state that I don't view this as a question of one side being right and the other wrong. At this moment, with the Democrats in control of the White House and both houses of Congress, the Republican minority seems to be hell-bent on frustrating the Democrats' plans (and capable of doing so). But my criticism isn't reserved for today's minority party. I have absolutely no doubt that unless something changes, the next time the Republicans are in power, the roles will be reversed and the Democrats will be the obstructionists.

You can think the things President Obama wants to do are either right or wrong, but you can't deny the fact that, even with majorities in both houses of Congress, he can't do them. This truly is gridlock.

Some people think gridlock is a good thing. They think either (a) government should do less rather than more or (b) government is incapable of doing anything right (or both). In my opinion, you have to hold attitudes like those in order to be optimistic about the situation in Washington. However, there are some things only government can do. **Even the founding fathers, as leery of government as some were, created one. Many of today's problems are government-created, so government will have to solve them.**

I believe most Americans want to see the problems solved. Of course, they disagree on how best to do so. But our leaders should work together to find solutions and explain to the voters why compromise is necessary. **That's an important part of leadership . . . perhaps more important than simply resisting the other party's suggestions.**

The people in Washington may be of good will; certainly most of those I've met seem to be. They probably believe the positions they hold are the right ones. But they have to let go of their obsessions with re-election, personal preferences and politics as a contact sport. We need them to take up and solve the important problems, and I see no movement in that direction.

In fact, I see additions to the arsenal of delay and frustration. When I was a boy, filibusters – weeks-long orations – were employed on rare occasions to hamper legislative action. Now filibusters can be virtual, meaning no talking is required; you just say, "I filibuster." It takes 60 votes in the Senate to bring something to the floor over an objection. Thus, with filibusters more frequent, 60 votes have replaced 51 as the threshold for forward motion. (Since I'm from California, where it takes two-thirds of the legislature to approve a budget, I can assure you that supermajorities don't result in better decisions, just inaction.)

When I see tactics like this in use – and this brand of partisan warfare, where it's all about winning and losing – I tend to agree with Will Rogers: **"The more you observe politics, the more you've got to admit that each party is worse than the other."**

I don't think any elected official who puts re-election above all else can do the right thing when it comes to hard choices. If the decisions were easy and the remedies palatable to the electorate, they would have been implemented by now. Instead, the answers to today's problems will be painful and displease some voters (if not all). Here's how Wessel puts it:

> Imagine this plausible scenario: Public confidence in government continues to decline. Unemployment remains high. Americans demand more government services, more benefits and lower taxes.

> Politicians, seeking re-election, go along. Exhibit A: John McCain, the Arizona Republican who called for cutting Medicare as a presidential candidate last year and now, fighting for reelection to the Senate, proposes to erect new parliamentary obstacles to Medicare cuts.
>
> In this scenario, even deficit-fearing politicians avoid taking on the long-term deficit. [Syracuse University's Leonard Burman] imagines a White House political adviser saying: "Mr. President, if you raise taxes or cut popular programs, you or your party will be defeated in the polls and the bad guys will take over. The bad guys do not share your priorities and they do not care about the deficit. Therefore, you cannot effectively deal with the deficit."

Unusually for me, I have a remedy in mind. **Let's tell our elected officials we want solutions, not warfare; compromise, not intransigence. And let's try to elect moderates in both parties, not extremists.** I don't know if it'll work, but I don't see many alternatives.

I'll move toward my conclusion with a quote (per *The Times*) from former Republican Senate leader Alan Simpson, who has been selected to co-chair the commission on the deficit:

> There isn't a single sitting member of Congress – not one – that doesn't know exactly where we're headed. And to use the politics of fear and division and hate on each other – **we are at a point right now where it doesn't make a damn whether you're a Democrat or a Republican if you've forgotten you're an American.** (emphasis added)

And where is it that every single member knows we're headed? At a reception I was fortunate to attend earlier this month, Hank Paulson described the situation roughly as follows (I paraphrase):

> At the family level, we try very hard to leave the next generation better off than we are. But at the national level, we're living in the present and ignoring massive problems with which the next generation will be saddled.

Wessel ends with a quote from President Ronald Reagan, and I'll go along with him. In 1982, Reagan had to sell a package of spending cuts and tax increases. In other words, there was something for everyone to dislike. But Reagan didn't shrink from such things. Here's what he said:

> Do we tell . . . Americans to give up hope, that their ship of state lies dead in the water because those entrusted with manning that ship can't agree on which sail to raise? We're within sight of the safe port of economic recovery. Do we make port or go aground on the shoals of selfishness, partisanship, and just plain bullheadedness?

March 17, 2010

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Memo to: Oaktree Clients

From: Howard Marks

Re: Warning Flags

For about a year, I've been sharing my realization that there are two main risks in the investment world: the risk of losing money and the risk of missing opportunity. You can completely avoid one or the other, or you can compromise between the two, but you can't eliminate both. One of the prominent features of investor psychology is that few people are able to (a) always balance the two risks or (b) emphasize the right one at the right time. Rather, at the extremes they usually obsess about the wrong one . . . and in so doing make the other the one deserving attention.

During bull markets, when asset prices are elevated, there's great risk of losing money. And in bear markets, when everything's at rock bottom, the real risk consists of missing opportunity. Everyone knows these things. But bull markets develop for the simple reason that most people are buying – ignoring the risk of loss in order to keep from missing opportunity – just when elevated prices imply losses later. Likewise, markets reach their lows because most people are selling, trying to avoid further losses and ignoring the bargains that are everywhere.

The Never-Ending Cycle

Why do people buy when they should sell, and sell when they should buy? The answer's simple: emotion takes over. Price increases excite investors and encourage them to buy, and price declines scare them into selling.

When the economy and markets boom, people tend to assume more of the same is in the offing. They find little to worry about, other than the possibility that others will make more money than they will. Fear of loss recedes, and fear of opportunity costs takes over. Thus risk aversion evaporates and risk tolerance rises.

Risk aversion is absolutely essential in order for markets to function properly. When sufficient risk aversion is present, people shrink from riskier investments and prefer safer ones. Thus riskier investments have to appear to offer higher returns in order to attract capital. That's as it should be.

But when people get excited about the prospect of easy money – even if from assets or investment strategies that have become far too popular, turning into overpriced manias – they frequently drop their risk aversion and adopt risk tolerance instead. Thus they swarm into the investment *du jour* without concern for its elevated price and risk. This behavior should constitute an important warning flag for prudent investors.

In the same way that expanded risk tolerance accompanies appreciated asset prices and contributes to the risk of loss, so does risk aversion tend to rise in times of depressed prices, increasing the risk of missed opportunity. When people refuse to buy assets regardless of their low prices, they miss out on the best, lowest-risk returns of the cycle.

Recent History – on the Upside

Just as the recent market cycle was extreme, so was the swing in attitudes regarding the "twin risks." And thus so are the resultant learning opportunities.

Risk aversion was clearly inadequate in the years just before the onset of the crisis in mid-2007. In fact, I consider this the main cause of the crisis. (Last year, *DealBook*, the online business publication of *The New York Times*, asked me to write about what I thought had been behind the crisis. My article, entitled "Too Much Trust, Too Little Worry," was published on October 5, 2009. It offers more on this subject should you want it.) Here's the background regarding the early part of this decade:

Interest rates kept low by the Fed combined with the first three-year decline of stocks since the Depressionto reduce interest in traditional investments. As a result, investors shifted their focus to alternative and innovative investments such as buyouts, infrastructure, real estate, hedge funds and structured mortgage vehicles. In the low-return climate of the time, much of the appeal of these asset classes came from the fact that they promised higher returns thanks to their use of leverage, whether through borrowing, tranching or derivatives.

Given the high promised returns, investors forgot about (or chose to ignore) the ability of leverage to magnify losses as well as gains. Contributing to investors' rosy view of leverage's likely impact was their belief that risk had been banished by (a) the efficacy of the Fed and its "Greenspan put," (b) the combination of securitization, disintermediation, tranching, decoupling and financial engineering, and (c) the "wall of liquidity" coming toward us from China and the oil producing nations.

For these reasons, few market participants were afraid of losing money. Most just worried about missing opportunity. The unattractive outlook for stocks and bonds meant investors would have to be aggressive and innovative if they were going to earn significant returns in the low-return environment. Thus risk aversion (a) was unnecessary and (b) would be counter-productive. "You'd better invest in this new financial product," people were told. "If you don't, you'll miss out. And if you don't and your competitor does – and it works – you'll look out-of-step and fall behind." When contemplating a virtuous circle without end, investors usually think of only one word: "buy."

This describes the process through which fear of missed opportunity can overcome skepticism and prudence. And in this period, that's what happened. No one worried about losing money. Fear of missed opportunity drove most investors, and Citibank's Chuck Prince famously said, ". . . as long as the music is playing, you've got to get up and dance. We're still dancing." Although he worried about a possible decline in liquidity, he worried more about falling behind in the manic race to provide capital.

Recent History – on the Downside

The events from mid-2007 through late 2008 or early 2009 demonstrate the reverse in operation. The upward trend in home prices ground to a halt and subprime mortgages began to default in large numbers. Leveraged vehicles melted down. Credit became unavailable, and financial institutions needed rescuing. Recession caused spending to contract, and corporate profits declined. Bear Stearns, Merrill Lynch, AIG, Fannie Mae, Freddie Mac, Wachovia and Washington Mutual all required rescues. Bank capital, commercial paper and money market funds needed federal guarantees. After the bankruptcy of Lehman Brothers, people began to ponder the collapse of the financial system. As often happens in scary times, "possible" morphed into "probable," or at least something very much worth worrying about.

Now a vicious circle replaced the virtuous one of just a few months earlier. And with its arrival, the fear of losing money replaced the fear of missing opportunity. As I've said before, I imagine most investors' cry was, "I don't care if I ever make a penny in the market again; I just don't want to lose any more. Get me out!"

For most investors, no assumption was too negative to be true, and no potential return made the risk of loss worth bearing. High yield bonds at 19% yields. First lien leveraged loans at 18%. Investment grade bonds at 11%. None of these was sufficient to induce risk-taking.

As I wrote in "The Limits to Negativism" (October 15, 2008), "Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive." By the fourth quarter of 2008, risk aversion ruled and risk tolerance had disappeared. A skeptical view toward excessive pessimism was called for at a time of unprecedented low asset prices, but few people could muster it. The credit markets offered the highest returns in their history, but fear of losing money kept most investors from seizing the opportunity.

In the middle of this decade we saw a manic period in which losses were unimaginable. The resultant shortages of risk aversion and skepticism caused investors to buy at highs and assume unprecedented risks in order to avoid missing opportunity. This was followed – as usual – by a collapse in which no negative event could be ruled out and no return was high enough to induce buying, all because investors wanted nothing other than to avoid losing money.

This cycle produced a treacherous, low-return period in which it was very hard to find investments promising good returns earned with safety, and then a period of collapse in which there were bargains everywhere but few investors possessed the requisite "dry powder" and intestinal fortitude with which to buy. That's the background. Where do we stand today?

Signs of the Times

Optimism, adventurousness and unworried behavior characterized the pre-crisis period, and investor behavior reflected those attitudes. In my memo "It's All Good" (July 16, 2007), just before the onset of the crisis, I mentioned some of the warning signs in the credit markets:

> Unlike the historic norm, it's routine today to issue CCC-rated bonds. It's easy to borrow money for the express purpose of distributing cash to equity holders, magnifying the company's leverage. It's so easy to issue bonds with little or no creditor protection in the indenture that a label has been coined for them: "covenant-lite." And it's possible to issue bonds whose interest payments can be paid in more bonds at the option of the borrower.
>
> The first requirement for an elevated opportunity in distressed debt is the unwise extension of credit, which I define as the making of loans which borrowers will be unable to service if things get a little worse. This happens when lenders fail to require a sufficient margin of safety. . . .
>
> The default rate in the high yield bond universe is at a 25-year low on a rolling-twelve-month basis. Under such circumstances, how could the average supplier of capital be expected to maintain a high level of risk aversion and prudence, especially when doing so means ceding all the loan making to others? It's not for nothing that they say "The worst of loans are made in the best of times."

The inspiration for today's memo came as my pile of clippings began to swell with indications that pre-crisis behavior is coming back. Here are excerpts from a few, with emphasis added in each case:

On covenant-lite loans –

> **Are debt investors just stupid? That might help explain why they're buying covenant-lite loans again.** These deals, which carry few restrictions on borrowers, became a standard bearer for easy money. They may have helped some companies limp through the downturn – but they've left lenders saddled with lots of risk and little return.
>
> It's easy to see why companies like covenant-lite loans. . . . But for owners of the debt, the attraction is far less clear beyond the familiar short-term reach for yield. . . .

> Lyondell Chemical is paying [Libor plus 400 basis points] on its recent $500 million covenant-lite deal. And the energy refiner will emerge from bankruptcy with a much slimmer debt load than before it filed for Chapter 11.
>
> Lyondell's terms are better than 2007's crop of covenant-lite loans, to be sure, but lenders still are essentially relinquishing their right to force companies into paying them more money, or exiting the loan entirely, should their creditworthiness tumble.
>
> So why are lenders doing it again? Lyondell Chemical's answer: investor demand for higher yielding assets. This is a familiar mantra while official interest rates remain low. **But lenders should be mindful of loosening standards or risk finding themselves once again on the short end of the stick.** ("Don't call it a comeback," *breakingviews*, April 5)

On payment-in-kind loans and flexibility –

> **Clint Eastwood's Dirty Harry character famously held a gun to a suspect and asked: "Do you feel lucky?" Investors in credit markets seem to be saying yes,** if Cerberus' refinancing of Freedom Group, maker of Remington firearms, is any indication.
>
> A deflating gun bubble backfired on the private equity firm's plans last year for an initial public offering of Freedom. Now trigger-happy credit investors are taking off their safeties and letting Cerberus unload some of its stake.
>
> The $225 million of notes are useful ammo for Cerberus. They allow Freedom to either pay the interest in cash or half in cash and half in additional notes at the company's discretion. The financing allows Cerberus to get cash back on its investment today by buying back preferred stock held by the private equity group ahead of an eventual IPO. . . .
>
> The buyers of these notes, though, are taking their chances. Freedom doesn't look overleveraged according to its historic cash flow – the company's debt level is about three times "adjusted EBITDA" for 2009. But sales of rival gun-makers are continuing to fall. . . .
>
> Moreover, these sorts of notes are notoriously difficult to price. The investor has to figure out the risk of the company encountering cash flow problems, whether the firm will actually pull the toggle trigger, and how much the PIK feature may reduce their potential recovery in the event of default. Indeed, many investors took drubbings on similar notes issued at

the top of the credit boom. **Caution is warranted when investors remove their trigger locks.** ("Do you feel lucky?" *breakingviews*, March 31)

On initial public offerings –

> **It is springtime for IPOs. . . . KKR and Bain, two of the most aggressive private-equity firms during the buyout boom, are now as aggressively looking to cash out**. They are leading what is expected to be a season of IPOs as long as the markets continue to stabilize or climb. The IPOs would allow the firms to partially cash out their stakes and return money to investors. They also could use the proceeds to pay down the sizable debt used to finance the takeovers. ("Bain, KKR to Push New Crop of IPOs," *The Wall Street Journal*, April 9)

On leveraged loans –

> Even as worries escalate about the ability of highly rated countries to fund themselves, there is a buzz at the other end of the credit spectrum. **Leveraged loans, a source of funding for private-equity acquisitions, are drawing investor interest again after a long period in the doldrums.**
>
> **In the U.S., there are signs of life in the collateralized-loan-obligation market, with the year's first deal not only refinancing an existing CLO but bringing in new money, too.** In Europe, HarbourVest Partners is launching a listed fund to invest in mid-market leveraged loans. Leveraged-finance bankers are more bullish, and new loans have started to flow. . . .
>
> There are wider implications, too: **Cash moving into the loan market represents a greater willingness to hold more illiquid assets, an important development. . . .** ("A Pulse Finally Returns to the Leveraged-Loan Market," *The Wall Street Journal*, April 12)

On dividend recaps –

> **Blackstone Group LP and other private-equity firms are accelerating sales of junk bonds and leveraged loans to pay themselves dividends in a sign the market for the riskiest debt may be overheating.**
>
> Apria Healthcare Group Inc., owned by Blackstone, is seeking consent from bondholders to sell notes to issue a dividend, following at least six similar offerings this year, according to data compiled by Bloomberg.

Including loans, companies have raised $10.8 billion in debt to fund payouts this year, compared with $1 billion in all of 2009 and $1.3 billion in the prior 12 months, according to Standard & Poor's LCD.

Private-equity firms are taking advantage of record high-yield, high-risk bond sales and a rally in loans to extract cash from companies they own, awaiting a rebound in leveraged buyouts and initial public offerings. So-called dividend deals, which permeated debt markets in 2006 and 2007 before the credit seizure, may signal investors are becoming too complacent, said William Quinn, chairman of American Beacon Advisors Inc.

"You start to be concerned that you're increasing leverage, which was one of the things that created these problems in 2008," said Quinn, who helps oversee $45 billion for the fund manager in Fort Worth, Texas. **"I understand why private-equity firms do it, but I would be concerned."** ("Dividend Deals Rebound as Blackstone Seeks Cash," *Bloomberg*, April 16)

Companies may increase borrowing to pay shareholder dividends in a record year for junk bonds, Standard & Poor's said. . . .

"We are starting to see the proceeds of high-yield issues being channeled to shareholders as dividends, something that is less-welcome from a credit perspective, reminiscent of the leveraged finance market back in 2007," analysts led by Taron Wade wrote . . . .

Companies owned by LBO firms in 2007 issued a record 6.1 billion euros of loans in the first half to pay dividends to shareholders, data compiled by Fitch Ratings show.

Private-equity firms "essentially decreased the risk of their portfolio equity investments, boosting their near-term equity returns at the expense of the credit quality of the companies themselves," according to S&P. ("Junk Bond Issuers Increase Dividend Deals, S&P Says," *Bloomberg*, April 20)

On collateralized loan obligations –

Citigroup is set to launch its second leveraged loan structured products transaction this year, this time for a large private equity client, as **debt managers and bankers look to revitalise the markets which drove the buyout boom. . . .**

If the transaction goes ahead soon, it will be only the second CLO to be sold since the beginning of 2009. Last month Citigroup structured a $525m CLO managed by US fund manager Fraser Sullivan Investment Management. . . .

Leveraged finance bankers are hopeful the CLO market can take off again as it would provide greater availability of finance for leveraged loans, the engine of the private equity industry. The market for CLOs ground to a halt after the collapse of Lehman Brothers pushed credit markets into freefall. Even the most actively traded leveraged loans lost as much as a third of their face value in the depths of the crisis. ("Citigroup markets second CLO," *Financial News*, April 19)

On buyouts –

Private equity firms bear some resemblance to children at a fairground: they jump on a ride as dealmaking gathers pace, whizzing faster and faster, before jumping off as the cycle slows down. As the ride starts to gather pace again, buyout firms are back, with some eyeing the biggest rides. (Emphasis in the original)

Mega-deals – transactions over $10 bn that were favoured in the boom years of 2006-2008 but have been crimped by the lack of debt – are making a comeback. Last week, Blackstone Group and other investors were in talks to acquire financial data processing company Fidelity National Information Services, according to The Wall Street Journal.

The acquisition of Fidelity, which has a market capitalisation approaching $10 bn and about $3 bn in debt, would be the largest leveraged buyout since the credit crisis struck. . . .

Bankers and buyout executives said the resurrection of large buyouts was being driven by a booming high-yield bond market. With low interest rates in Europe and the US, investors are more willing to take the risk of weaker credits because it allows them to secure yields unavailable in other forms of lending. ("Are dealmakers ready for another white-knuckle ride?" *Financial News*, May 10)

On investor psychology –

Irrational equanimity is back. Not only are developed market stocks back to pre-Lehman levels, but investors' comfort levels are in a zone not seen since the eve of the credit crisis in early 2007. Apart from US stock indices, this shows up in the price investors will pay to insure

> against volatility, with the CBOE Vix index down to its lowest since the crisis eve of July 2007, and in sharp reductions in cash cushions held by institutions.
>
> Merrill Lynch's widely followed survey of fund managers . . . finds that more now want companies to pay higher dividends or make more capital expenditures than see them pay down debts. . . .
>
> Such equanimity is not totally irrational. Macroeconomic data in the past month have run ahead of expectations. When the herd trampling forward is this bullish, it is not a good idea to stand in its way. But it would be easier to feel comfortable with current share price levels if investors showed a little more unease. **Complacency on this scale suggests risk of a correction.** ("*Investor sentiment*," Financial Times, April 14)

Just as one returning swallow doesn't make a summer, anecdotal evidence of rising risk tolerance does not mean entire markets have returned to dangerous levels. But it's a fact that issuers and investment bankers can do things today that they couldn't do a year or two ago. **The door is open to transactions that wouldn't be possible if risk aversion were running high. The clear inference is that fear of loss has declined and fear of missed opportunity has come back to life. That's an important observation.**

<u>Where Did the Unease Go?</u>

Just a short while ago, I believed investors had been sufficiently traumatized that the willingness to bear risk would be absent for years. But it came back in just a matter of months. What explains that?

For one thing, the crisis – as painful as it was – was surprisingly brief. The worst of it began in the third quarter of 2008 with the disclosure of weakness at financial institutions. The onset of the most intense part of the crisis can be dated to Lehman Brothers' September 15 bankruptcy filing. Remarkably, high yield bonds began to recover just three months later, with most of the indices showing gains of roughly 5% for the month of December. So in the credit markets, the worst pain lasted only about three months and quickly gave way to recovery.

And what kicked off the recovery? Fear of missing opportunity was resurrected by the Fed and other central banks which forced interest rates on short-term government debt to near zero. It might have been the banks' intent, or it might have been an unintended consequence, **but those low rates pushed investors to engage in riskier behavior**. The returns on T-bills and money market funds went to a fraction of a percent, meaning investors had to crawl out on the limb in pursuit of returns they could live with.

Further, governments flooded the system with liquidity and produced the opposite of crowding out. When governments are big issuers of debt, it can be hard for non-government issuers to raise money. But when governments are big buyers of securities instead, the capital they inject into the markets can make it easy for others to issue securities.

> Investors flooded risky companies with money in March even as the government prepares to shut down a key engine driving one of the greatest corporate-bond rallies in history.
>
> A total $31.5 billion in new high-yield debt, otherwise known as junk bonds, hit the market through Tuesday, exceeding the previous monthly record in November 2006. Partly propelling the activity: The Federal Reserve's massive mortgage-buying program, [which recently came to an end].
>
> By buying $1.25 trillion of mortgage securities, the Fed absorbed a flood of assets that otherwise would have needed buyers. That kept money in the hands of investors, who went searching for something else to buy. The Fed's underpinning encouraged investors to seek riskier, higher-yielding securities. A natural choice: corporate bonds. ("Bonds Cap Epic Comeback," *The Wall Street Journal*, March 31)

One of the prime tasks investors must perform is to stay alert to extreme behavior and take hints as to what we should do from what we see taking place around us. This is best expressed in Warren Buffett's helpful reminder: "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."

Investor behavior between 2003 and mid-2007 was sending some very worrisome signals. It's obvious in retrospect that all one had to do was take heed and lean in the opposite direction. But observations regarding the past are no help for purposes other than education. For observations to be profitable, they must relate to the present and the future.

Investors have made a substantial move back in the direction of pre-crisis behavior. That behavior has to be recognized and monitored. The pendulum has moved away from the depression, panic, skepticism and excessive risk aversion we saw in the fourth quarter of 2008, and with the disappearance of those characteristics have gone the great bargain opportunities.

Uncertainty and fundamental weakness at the depth of the crisis were offset by irrationally low prices and the potential for a rebound in risk tolerance, making most assets a screaming buy. With most of the great bargains gone – along with excess risk aversion – macro uncertainties should no longer be overlooked. **Thus the caution, discipline, patience, selectivity and discernment that were so unnecessary in 2009 are absolutely essential today.**

*　　*　　*

I started this memo in late April, but I didn't get it out before Greece's financial crisis burst into full bloom last week. This gives me an opportunity to discuss the significance of the recent developments (not the substance, however; that'll have to await another memo).

Investing defensively requires that when everything seems to be going well and investors are feeling positive, we must sense the implicit danger and prepare for negative developments.

In the mid-2000s, I began to warn that with asset prices full, investors optimistic and their behavior aggressive, it was important to worry about things that could come along to derail the markets. When asked what they might be, my list of possibilities would go like this:

- recession,
- credit crunch,
- $100 oil,
- collapse of the dollar,
- exogenous events such as terrorist attacks, or
- something else.

The most dangerous possibility, I pointed out, was the last one. Markets and market participants can adjust to things they see coming. What usually knocks them for a loop are things they don't anticipate. "We're not expecting any surprises" is one of my favorite oxymorons. By definition, surprises are things that aren't anticipated, and thus their arrival can be traumatizing.

Just a few months ago, I published a memo called "Tell Me I'm Wrong" (January 22), in which I listed a number of things that worried me. These included our reliance on government stimulus and artificially low interest rates; the uncertain outlook for consumer spending, jobs and state and municipal finances; and the risks pertaining to inflation, exchange rates and interest rates. Here's how I concluded:

> My goal in this memo isn't to express a forecast. I know no forecast – and certainly not mine – is likely to be correct. What I do want to do is caution that the considerable risks I see may be less than fully appreciated by those setting asset prices today. The greatest market risks lie in failure of the macro economy to live up to the expectations embodied in today's prices. . . .
>
> Most people view the future as likely to repeat past patterns, which it may or may not do. They tend to think of the future in terms of a single

scenario, whereas it really consists of a wide range of possibilities. (Remember Elroy Dimson's trenchant observation that "risk means more things can happen than will happen.") And to the extent they do consider a variety of possibilities, few people include ones that haven't been part of recent experience.

The uncertainties discussed above tell me today's distribution of possibilities has a substantial left-hand (i.e., negative) tail, probably greater than at most times in the past. The proper response should be to discount asset prices, allowing a substantial margin for error. Forecasts should be conservative, yield spreads should incorporate ample risk premiums, valuation parameters should be below the long-term norms, and investor behavior should be prudent.

Conspicuously missing from my list of worries was Greece (and all it entails); thus it falls firmly in the category of "something else." Last week it dominated the headlines and depressed markets worldwide. Thus in this short time I have proved two things: first, I know little more than others about what the future will bring and, second, when most investors turn optimistic, it becomes important to worry.

The issue of Greece and its debt has been on investors' radar screens for months, but few people seem to have understood its ramifications and the risks it presented to the markets. Then, in recent weeks, things began to be discussed daily in the media – such as Greece's profligacy and the risks involved in admitting it to the European Union; Europe's lack of an established mechanism for dealing with a problem of this nature; and its reliance on Germany to contribute voluntarily to a solution – that in hindsight it seems should have been obvious. This tells us a few important things about investing:

- Investors generally overestimate their ability to see the future, and the worst of them act as if they know exactly what lies ahead.
- It's important to worry about what's coming next. The fact that we don't know what it is shouldn't permit us to think there's nothing to worry about.
- Low asset prices allow us to invest aggressively, without much consideration given to worrisome fundamentals and the possibility of negative surprises. But as prices rise, so should our degree of concern over these things.

The bottom line is this: the fact that we don't know where trouble will come from shouldn't allow us to feel comfortable in times when prices are full. The higher prices are relative to intrinsic value, the more we should allow for the unknown.

The recovery of 2009 in the face of significant fundamental uncertainty meant that the markets were reincorporating optimism and thus vulnerable to surprise and disappointment. This in itself should be sufficient to induce caution.

May 12, 2010

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Memo to: Oaktree Clients

From: Howard Marks

Re: It's Greek to Me

In the early part of this decade, I reviewed a few books for the *Sunday Los Angeles Times*. Here's how I began my assessment of Pete Peterson's *Running on Empty* in 2004:

> Consider Sam. He's always been regarded as the brightest guy in town, and maybe the handsomest. He has the best job and lives in the best house. He spends aggressively – detractors would say hedonistically – to support a lifestyle that many others envy, but he shows good character by providing generously for his sick and elderly relatives.
>
> There are, however, a few problems. In recent years, he's been spending more than he makes, and his expenditures appear likely to grow faster than his income. He covers each year's shortfall by borrowing from other members of the community. (They've always been glad to lend him money because of his good standing in town.) But this adds increasingly to his debt, and thus to the next year's interest (and shortfall). In other words, he seems to follow Winston Churchill's dictum: "It saves a lot of trouble if, instead of having to earn money and save it, you can just go and borrow it."
>
> Finally, with the number of family members Sam cares for increasing, with him promising each of them an increasing stipend, and with his relatives – even the sick ones – living longer, it seems clear that in the future, the cost of supporting them will grow considerably faster than his income.
>
> An annual deficit. Attachment to a lavish lifestyle. Growing indebtedness and related increases in interest costs. Dependence on others to finance the shortfall and the risk that those lenders will withdraw their loans or charge higher interest rates. A commitment to pay for the welfare of others that threatens to grow out of control.

Pete's book focused on the tendency of the United States to ignore the cost of its social programs, run deficits and expand debt, and the "Sam" in my analogy was, of course, Uncle Sam. But now other nations have jumped the line and usurped the above description. Like most of Western civilization, it started with Greece.

Because I was in London much of the time since Greece burst into prominence, I may be able to add some insight from a European vantage point. This period in London was unusual for me, in that with this topic in the headlines I was far more a student than a teacher. Most Americans don't start off sensitized to international economics and, especially, currency matters. It's been challenging to organize all I've learned and boil it down for a memo, but here it is.

Strange Bedfellows

"Shared values" is one of the things I credit for Oaktree's success over the years. All of Oaktree's senior managers are conservative, cautious people; we all agree that risk control and consistency hold the keys to long-term investment success; and we all put clients' account performance ahead of our company's profit. Shared values make it easy to run an organization and particularly easy to reach agreement on policies and tactics.

Now imagine what it would be like to run an enterprise where (a) some of the constituents believed much more in thrift, discipline and transparency than others and (b) there was no mechanism for making sure everyone played according to the agreed-upon rules. Welcome to Europe.

In the 1950s Belgium, France, Italy, Luxembourg, the Netherlands and West Germany came together to form the European Coal and Steel Community, European Atomic Energy Community and European Economic Community, which in 1967 combined as the European Community. Denmark, Ireland and the U.K. joined in 1973, and Greece, Spain and Portugal joined in the 1980s. Membership has since expanded to 27 nations, and the name "European Union" (E.U.) was adopted in 1993. In 1999, eleven nations (since expanded to 16) agreed to form the euro zone and replace their individual currencies with the euro. Europe seemed to have accomplished the daunting task of pulling together its nations and adopting a single currency. This was a delicate balancing act, but for years it seemed to go quite well.

It was a requirement for success that all the nations share fiscal policy. However, as in most economic alliances, there were incentives to nibble at the rules. And, believing more is better, the E.U. admitted nations with less uniform values. The desire to create a common currency and expand the reach of the union – to achieve a scale more comparable to economic powers like the United States – colored decisions regarding expansion and ultimately led to trouble.

To get a feeling for what happened, let's say you and I are such good friends that we decide to combine our economic strength to apply together for a credit card with better terms and a higher limit. We agree we'll each (a) refrain from spending more than we earn and (b) receive and pay that part of the bill that relates to our own charges. All goes well, and eventually we agree to admit a third member to our association. But the new member doesn't share our commitment to thrift and integrity, wants to live a better life than he can afford, and thus charges more on the card than he earns. Our strong combined credit rating enables him to do so, and his balance on the credit card starts to swell. When it comes out that our association is heavily indebted, we chip in to pay off the unpaid balance, even though only one of us ran it up. In fact, since the prodigal third member spent more than he made, he has nothing to contribute to paying off the debt; thus you and I – despite having behaved more responsibly – are stuck with the burden.

Greece is that new member of the arrangement, and it (like a number of other countries) wanted to give its people a better life than they can afford, financed from the public treasury. Without membership in the E.U. – or if the rules on deficits had been enforced – Greece's economic reality would have limited what it could do for its citizens. But E.U. membership enabled it to borrow and spend to excess. Here's what the Bank of Spain's governor said in April 2007: "The single monetary policy has meant that excessively loose conditions for our economy have been almost continuous" (*Telegraph.co.uk*, May 30). The same was true of Greece.

My English friend Rodney Leach is a Member of Parliament and a committed leader of the "Eurosceptics" who have campaigned to improve the E.U. and prevent Britain from adopting the euro in place of sterling. His draft of a coming paper influenced my understanding of the situation: "Once inside the Club," he writes, " . . . the Mediterraneans resumed their old habits. The temptation was irresistible to borrow at the low interest rates bestowed on them by Germany's participation. Greece in particular indulged itself by completely abandoning financial discipline."

Greece was able to violate the agreed-upon 3% cap on E.U. members' deficits, abetted by generous capital markets and the failure to enforce the limit, and it engaged in financial transactions designed to hide its growing debt. It bears noting that much of what's true today about Greece has been true for years. But people didn't understand its significance to the extent they do today, or didn't find it worrisome, and short-term-oriented politicians had every incentive to ignore the problem rather than confront it and admit that their noble experiment was fraying.

Thus it emerged in early April that Greece and Greek companies had run up substantial debts that would be hard to repay. It didn't take long for people to figure out that the same was true about the rest of the "PIIGS": Portugal, Italy, Ireland, Greece and Spain. In May, some unfortunate remarks by Hungary's Finance Minister made it a candidate for similar treatment. Then Estonia came under the spotlight, and the process seemed to cascade non-stop.

A Problem of Substance

The real problem in Greece and the other countries – especially what Rodney calls the "Mediterraneans" – isn't one of deficits and debt. Those are merely the results and the symptoms. And if the problem were Greece alone, the smallness of its economy and financial system would render it easily fixable. The problems are more substantial, structural and widespread. (I looked at 17 European nations; they all ran deficits in 2009, and only two of those deficits were below the E.U.'s target of 3% of GDP. In ascending order, the deficits in Belgium, Cyprus, Slovakia, France, Portugal, Spain, the United Kingdom, Greece and Ireland were all between 6% and 14%.)

The ingredients that contributed to the European crisis are many:

- Slow-growing, unproductive and uncompetitive economies.
- Low birthrates and aging populations. ("In the 1950s there were seven workers for every retiree in advanced economies. By 2050, the ratio in the European Union will drop to 1.3 to 1." – *New York Times*, May 23)
- Generous benefits and social services; cradle-to-grave safety nets.
- Extensive vacations and strict limits on the work week.
- Early retirement.
- Artificially high debt ratings and resultant low interest rates.

In "What Worries Me" (August 28, 2008), I expressed concern about the fact that Americans expect the world's highest standard of living even though the U.S. is no longer a leader in manufacturing output and global competitiveness. Certainly this is the case in spades for Greece, whose economy is largely irrelevant but which wanted to meet its people's demands.

In April, as the problem began to unfold, I heard a Greek taxi driver express his worry on the radio: "I might not be able to retire at 53," the average retirement age. How can it be rational for a nation with a limited economy to enable its citizens to retire at age 53? Well, it isn't. Greece was able to outspend its revenues for years because it benefited from the "reflected halo" of the E.U.'s financial strength and low euro-related interest rates.

On June 4, 2005, the *International Herald Tribune* carried an op-ed piece by Thomas Friedman in which he presciently observed the following:

> . . . [the forces of globalization are] eating away at Europe's welfare states. It is interesting because French voters are trying to preserve a 35-hour work week in a world where Indian engineers are ready to work a 35-hour day. Good luck. . . .
>
> I feel sorry for Western European blue-collar workers. A world of benefits they have known for 50 years is coming apart, and their governments don't seem to have a strategy for coping.
>
> A few weeks ago, Franz Muentefering, chairman of Germany's Social Democratic Party, compared private equity firms which buy up failing businesses, downsize them and then sell them to "a swarm of locusts."
>
> The fact that a top German politician has resorted to attacking capitalism to win votes tells me just how explosive the next decade in Western Europe could be, as some of these aging, inflexible economies which have grown used to six-week vacations and unemployment insurance that is almost as good as having a job become intimately integrated with Eastern Europe, India and China in a flattening world. . . .
>
> Next to India, Western Europe looks like an assisted-living facility with Turkish nurses.

In a nation with closed borders, a government can do almost about anything it wants. It can print money with which to buy things for people who don't earn those things themselves . . . as long as sellers will accept that newly printed money at face value. **But in a global economy, competitive forces make it hard for people – or countries – to live better than their output justifies.**

Less fundamental but more colorful, I've learned about a number of factors which exacerbate the situation in Greece and elsewhere. While just anecdotal, these tales are rampant in Europe:

- As may be typical of Mediterranean nations, compliance with Greek tax laws is, shall we say, "spotty." In this country of 11 million people, just a few thousand report incomes above €100,000.
- There's a box to check on the tax form if you have a swimming pool, and 324 residents of Athens said "yes." However, when tax investigators checked satellite photos, they got a slightly different figure: 16,974. That's 2% compliance. (*The New York Times*, May 10)
- As part of the unorthodox arrangement, these countries have significant "black" or "shadow" economies. In Greece, 20-30% of transactions are said to take place in cash and/or through overseas bank accounts, unreported in both cases.
- The prevailing rule in Greece seems to be "4-2-4." If you have a pending tax obligation of €10, you meet with the tax collector. You hand him four for himself, you pay the authorities two, and you keep four. It's not a fluke that the typical Athens tax collector, with a salary of €50,000, is said to own real estate worth €2 million.
- Going the proverbial baker's dozen one better, workers in Greece's public sector had quite a deal: they were paid two "bonus months" per year.
- In Spain, half of all employees are unionized and protected by very strict work rules that limit efficiency and essentially preclude layoffs. This means any steps to cut costs fall on the rest of the work force, which is hit disproportionately.
- It seems that Italy (an E.U. founder but also a "Mediterranean") maintains "a fleet of more than 626,000 official cars, more than 10 times the number in France, Germany or the UK." (*Financial Times*, May 12)

Together these things – low output, high government spending, under-the-table business dealings, tax evasion, and financial profligacy – represent a recipe for trouble. **Today's developments merely prove that things that don't make sense can't go on forever**:

- Perpetually spending more than you bring in.
- Enjoying a standard of living you can't afford.
- Running an annual deficit that increases constantly as a percentage of GDP.
- Owing amounts that increase constantly as a percentage of GDP.
- Doing all the above while having a currency as strong – and an interest rate as low – as in nations where these things are not the case.

Things can go on longer than they should, and these probably have, but eventually there's a price to be paid. The world is up in arms today over everything that's wrong with the European financial picture, even though these conditions probably aren't much changed from a few years ago. It's just that now people have decided to focus on them.

<u>The Role of Debt</u>

As I mentioned above, debt isn't the problem, or the cause of the problem. But it has been the facilitator.

In "The Long View" (January 9, 2009), I wrote (albeit without reference to Greece) about a strong uptrend over the last few decades in what I called "expansiveness":

> Every business, government, non-profit organization or individual has a certain amount of equity capital, net worth or surplus. That capital, in turn, will support a certain level of activity: production and sales, lending, government action, charitable grants or consumption. **But over the last several decades, if you wanted to do more of these things than your capital permitted, you could borrow capital from someone else.**

Without credit – I think back to my pre-credit card college days of 45 years ago, for example – you couldn't spend money you didn't have. Thus you couldn't buy things you couldn't afford. Then the miracle of credit came along and it became easy to get in over your head.

What would have happened if governments couldn't finance deficits by issuing debt? Greece would only have been able to pay the benefits it could afford. Less pleasant, but perhaps healthier.

And what would have happened if builders weren't able to borrow, and thus had to sell each newly built home before they could erect the next? Spain wouldn't have been the site of a boom in which 2.8 million homes were built (with only 1.5 million sold), and with as many building permits issued as in France, Germany, Italy and the Netherlands put together.

The Wall Street Journal of November 24, 2008 carried the following quotation from Irving Fisher, writing 76 years ago ("The Debt-Deflation Theory of Great Depressions," *Econometrica*, March 1933):

> When it comes to booms gone bust, "over-investment and over-speculation are often important; but they would have far less serious results were they not conducted with borrowed money."

While this statement wasn't made with regard to Greece or even to government activities in general, it is clearly relevant to the current situation.

In recent years, most of the nations of the world spent more than they took in to give their citizens more of what they wanted. As long as the capital markets were open, few could think of a reason why this policy wouldn't work forever. Economic units all over the globe were able to borrow to cover deficits. All that mattered was the ability to service the debt, even if that required borrowing money to pay interest. No one seemed to demand the ability to repay.

When I was younger – in what seems like a distant past – national debt began to expand, and I remember heated debate regarding the significance, wisdom and likely consequences of that trend. The subject receded in recent years, since every nation now does it to some extent and people became inured to the controversy, as they tend to do.

Two sentences stand out on this subject, from Bill Julian of Bill Julian Research on April 11. He quotes John Maynard Keynes as having said, "Government debt is really debt we owe to ourselves. So it doesn't matter." But today, most nations' debt is no longer all "to ourselves," as nations with surpluses are largely financing the ones with deficits. Thus it's hard to conclude national debt doesn't matter. Welcome to 2010.

In the "old days," government deficits were often part of counter-cyclical stimulus, a concept with which Lord Keynes is identified. It seems logical that when its economy is depressed, a nation will spend more than it receives in taxes in order to stimulate. Then, in times of prosperity, it will cut expenditures, run a surplus and pay down debt. But permanent deficits appeared in the late twentieth century, and thereafter national debt has grown in good times and bad. The idea of national debt being repaid has evaporated. Today, public and private institutions in Greece, Spain and Portugal owe €2 trillion to foreigners, with no possibility of repayment in sight.

<u>Solutions and Stumbling Blocks</u>

Thus far, most of the actions being taken to address the crisis are of two types: financial maneuvers to calm the financial markets in the short term, and austerity measures designed to reduce deficits in the long term.

The United States' credit crisis of late 2008 serves as a model for what must be done. The elements that arise in a credit crisis are consistent: uncertainty regarding the future, fear of credit losses, and refusal to make loans. **Financial systems run on confidence, and, when confidence dries up, things can grind to a halt.** Clearly, then, the most immediate efforts must be to restore confidence and keep credit flowing.

This problem is particularly severe at financial institutions (and what is a national economy today other than a financial system, hopefully with a manufacturing sector tacked on?). Financial institutions are, by definition, marked by high leverage, and if confidence declines, the providers of credit tend to ask for their money back. Since these institutions never have enough cash on hand to satisfy the demands of the would-be withdrawers, they can fall prey to a run on the bank. The first task, then, is to restore confidence and keep capital available.

Thus, at the beginning of May, the E.U. put together a rescue package for Greece worth €110 billion. And then, when the possibility of contagion to Spain, Italy and Portugal began to be recognized, that was increased on May 10 to €750 billion (or $900 billion, a figure remarkably similar to the U.S.'s program). In addition, the European Central Bank established a program to buy government bonds of the affected nations, along the lines of our "quantitative easing."

Many European governments have announced plans to reduce deficits. Their tactics include reduced spending, freezes or cuts in public sector employment and wages, and higher retirement ages. Some have enacted tax increases to augment revenues. Greece even says it's going to start collecting more of the taxes that are owed. Austerity is all the talk in Europe, and some leaders are predicting periods of substantial suffering. That's what happens when a borrow-and-spend cycle that has advanced beyond prudence is brought to a halt.

It's important to recognize, however, that one potential solution – traditionally perhaps the easiest – isn't available to the members of the European Union: currency devaluation.

A key element in the situation is the absence of independently floating exchange rates. Think for a moment about international finance. Countries differ in terms of growth rates, productivity and inflation rates. In recognition of the differences, interest rates and exchange rates change relative to those of other countries. In general, countries that are better off in terms of growth, productivity and inflation will have stronger currencies and pay lower interest rates.

The easiest way for a nation with excessive foreign debt to solve its problem is through devaluation. If the drachma weakens relative to the deutschemark, a Greek who owes a German a certain number of drachmas now owes him fewer deutschemarks (of course, if the debt is denominated in deutschemarks, he now owes him more drachmas). This process can occur through an explicit devaluation or through hyperinflation, and we'd be overwhelmingly likely to see it in action from a standalone Greece.

Between 1980 and 2000, the drachma depreciated by roughly 85% relative to the deutschemark, a reflection of economic reality. But with the countries of Europe tied together with a single currency, this can't happen.

Nations throughout Europe are doing what they can. That means reassuring financial markets and implementing austerity measures, but not devaluing (as long as the debtor nations in question remain part of the E.U.).

<u>So, Will It Work?</u>

"Will It Work?" was the title of a memo I wrote on March 5, 2009, discussing whether the Obama administration's rescue plan would be successful. The problems were new and huge, like today's in Europe, and the solutions being attempted were untested, also like today's.

The last section of "Will It Work?" was devoted to the three things I said had to be accomplished in order for the rescue to be effective: delever the economy, replace the capital that has been destroyed, and restore confidence. The recipe in Europe is no different, although the U.S. government had to shore up the financial institutions, whereas in Europe governments first have to support other governments.

In addition, there are wrinkles in Europe that the U.S. didn't face to the same degree. They can make it challenging to solve problems and especially to reach agreement quickly:

- The European Union consists of 27 sovereign nations, each with its own central bank and finance ministers. In addition there are the European Central Bank ("ECB"), the European parliament and the E.U. ministers.
- The countries have very different political views and are led by people from all over the political spectrum.
- The approach of nations to the problem will be colored by history that in some cases includes war and occupation. Countries will be asked to bail out others they fought against in the past.
- Finally, the countries' financial status varies widely. Only a few – primarily Germany – can contribute meaningfully to a bailout, and they will be asked to carry the vast majority of the burden. Will they be willing to do so?

As an indication of the intra-European differences, *The Wall Street Journal* said the following on June 15:

> Germany views the crisis on the euro zone's Southern fringe as a symptom of other countries' failure to copy Germany's fiscal discipline and structural overhauls to its economy. Its proposed remedies focus mainly on pushing other countries to cut budget deficits.
>
> France, however, believes Germany's large trade surplus and weak domestic demand are part of the euro zone's problem, since they force weaker economies to pay for their imports with debt, rather than through exports to the German market, Europe's biggest.

In addition to political complexity, efforts to solve the problem will run into two important issues:

- **Austerity measures and tax increases are anti-stimulative, and they are being applied at a time when the economies in question are weak and need stimulus. Economic historians such as Ben Bernanke recognize that adding liquidity is the best way to deal with a slowdown, and that the withdrawal of liquidity exacerbated the Great Depression.**

- **In the long run, reducing deficits and debt will not be enough. The countries in question have to increase their productivity and competitiveness.**

In "Will It Work?" I quoted from Paul Krugman (*The New York Times* of February 16, 2009):

> As the great American economist Irving Fisher pointed out in the 1930s, **the things people and companies do when they realize they have too much debt tend to be self-defeating when everyone tries to do them at the same time**. Attempts to sell assets and pay off debt deepen the plunge in asset prices, further reducing net worth. Attempts to save more translate into a collapse of consumer demand, deepening the economic slump. (Emphasis added)

The yoking together of the European nations introduces some interesting ramifications. Some Northern European export economies – Germany in particular – are doing quite well. At this stage of the cycle, they might be considering rate increases and their currencies might be strengthening. But it's doubtful the ECB will raise rates anytime soon, and the euro has weakened versus other currencies. Thus, for example, the German economy and German exports will be stimulated when they arguably don't need it. Germany will export more than it otherwise might have, with some of its gains recirculated in the form of aid to other countries. Good so far, but possibly inflationary. Complicated and not easy.

The analysis of sovereign debt is in large part political, not economic. Thus the open questions are political, as described above, complicated by the multi-national aspect of the E.U. and the absence of provisions for disciplining financial non-compliers, ejecting members or winding down the Union.

But as we saw in the U.S. in 2008 and 2009, there should be little doubt that everything possible will be done to save the euro and the E.U. (albeit perhaps with one or two fewer members and/or a touch of "debt rescheduling"). They're likely to continue to exist, but many of the key questions in Europe surround the level of economic vibrancy we'll see.

My purpose in writing this memo was to summarize and explain the developments in Europe, and that's the vein in which I started. But then I started to think more broadly.

<u>We Have Met the Enemy and He Is Us</u>

According to *The New York Times*, a leading central banker addressed his legislature on June 9 regarding his country's fiscal operation, which he said "appears to be on an unsustainable path."

> "**A variety of projections** that extrapolate current policies and make plausible assumptions about the future evolution of the economy," he said "**show a structural budget gap that is both large relative to the size of the economy and increasing over time**. . . ."
>
> "In addition, government expenditures on health care for both retirees and non-retirees have continued to rise rapidly as increases in the costs of care have exceeded increases in incomes. **To avoid sharp, disruptive shifts in spending programs and tax policies in the future, and to retain the confidence of the public and the markets, we should be planning now how we will meet these looming budgetary challenges**." (Emphasis added)

Greece? No. Spain? No. Portugal, Italy or Great Britain? None of the above. **That was Ben Bernanke speaking before the Budget Committee of the House of Representatives.** Thus my use above of the most famous line from Walt Kelly's comic strip "Pogo." Greece and the other members of "Club Med" may be on the hot seat today, but few developed nations are exempt, and certainly not the U.S. The differences between the countries in the headlines and many others are matters of degree, not kind.

David Leonhardt's column in *The New York Times* of May 12 provides a good way to start in on this subject:

> It's easy to look at the protesters and the politicians in Greece – and at the other European countries with huge debts – and wonder why they don't get it. They have been enjoying more generous government benefits than they can afford. No mass rally and no bailout fund will change that. Only benefit cuts or tax increases can.
>
> Yet in the back of your mind comes a nagging question: how different, really, is the United States?
>
> The numbers on our federal debt are becoming frighteningly familiar. The debt is projected to equal 140 percent of gross domestic product within two decades. Add in the budget troubles of state governments, and the true shortfall grows

> even larger. Greece's debt, by comparison, equals about 115 percent of its G.D.P. today.
>
> **The United States will probably not face the same kind of crisis as Greece, for all sorts of reasons. But the basic problem is the same. Both countries have a bigger government than they're paying for.** And politicians, spendthrift as some may be, are not the main source of the problem.
>
> We, the people, are.
>
> We have not figured out the kind of government we want. **We're in favor of Medicare, Social Security, good schools, wide highways, a strong military – and low taxes. Dealing with this disconnect will be the central economic issue of the next decade, in Europe, Japan and [the U.S.]. . . .**
>
> As societies become richer, citizens tend to want better schools, better medical care and other government services. [The U.S.] is following that pattern, but without paying the necessary taxes. That combination has us on a course to Greece-like debt.
>
> As a rough estimate, the government will have to find spending cuts and tax increases equal to 7 to 10 percent of GDP. The longer we wait, the bigger the cuts will need to be (because of the accumulating interest costs).
>
> Seven percent of GDP is about $1 trillion today. In concrete terms . . . the combined budgets of the Education, Energy, Homeland Security, Justice, Labor, State, Transportation and Veterans Affairs Departments are less than $600 billion. (Emphasis added)

Leonhardt provides some data for "cyclically adjusted primary balance as a percentage of GDP" that make for frightening comparisons:

Portugal	- 2.8%
France	- 3.7
Spain	- 5.6
Greece	- 6.0
Iceland	- 6.5
Britain	- 6.8
United States	- 7.3
Ireland	- 8.2

The Times defines "primary balance" as ". . . a measure of each country's medium-term deficit as a percentage of GDP excluding interest payments and assuming that unemployment in all countries drops significantly (to what economists consider 'full employment')." In other words, these projections incorporate a good bit of optimism. The U.S. deficit is swollen by stimulus measures that should shrink, but the data still make us look bad in some pretty bad company.

The U.S. is better off than Europe in a number of ways:

- Its national debt isn't high as a percentage of GDP (according to CIA data, our ratio in 2009 was only 53%, versus 113-115% for Greece and Italy, and 62-77% for the Netherlands, the United Kingdom, Germany, Portugal and France).
- It benefits from having the world's primary reserve currency.
- Its Treasury securities are still a primary destination during any flight to quality (thereby reducing its interest costs).
- It possesses advantages in terms of top educational institutions, natural resources, creativity and intellectual progress.

On the other hand, its drawbacks include a tradition of deficit spending; heavy total indebtedness (especially at the household level); many of the demographic issues that I described as affecting Europe (e.g., aging population, potential for structurally high unemployment); costly entitlement programs; declining competitiveness and a shrinking manufacturing base.

Including the private sector, total U.S. debt stood at 358% of GDP in late 2008. That compares to about 200% of GDP prior to the Great Depression and a peak of 300% in 1933 (sources: Bureau of Economic Analysis, Federal Reserve and Census Bureau). **The U.S., too, will have to go through some major belt-tightening . . . painful if it starts soon, but much more so if it is delayed until the future promises are allowed to build up further.**

I think David Brooks put it very well in *The New York Times* on May 13:

> If you're elected president or prime minister in pretty much any country in the developed world today, you're faced with the same set of challenges: to reduce national deficits without choking off a fragile recovery; to trim the welfare state and raise taxes while still funding the things that lead to long-term growth; to try to enact brutally painful measures at a time when voters don't trust their leaders; to do it at a time when politics are polarized and a hundred different interest groups have the ability to block change.
>
> The chances that the world's leaders are going to be able to do these things successfully are between slim and none. It's hard enough to figure out the right mix of spending cuts and tax increases. It's nearly impossible to build a political majority willing to enact them. Sometime over the next decade or so, the world will probably suffer from another series of crushing fiscal crises with significant economic pain and maximum political turmoil.

While Brooks led off with the paragraphs reproduced above, he found "Glimmers of Hope" (the title of his column) in the constructive budgetary approach being adopted by the new governing coalition in Great Britain.

This assessment from the Milken Institute should provide some motivation for problem solving:

> By 2020, trillion-dollar deficits will become the norm even in years of solid economic growth and low unemployment, rather than an unpleasant aberration linked to a deep recession.
>
> Absent wrenching changes in fiscal policy, things will only get worse after that. The retirement of the baby boom generation and the growth of health costs at a rate far faster than the growth of GDP mean that government spending on Social Security, Medicare and Medicaid (which pays for most nursing-home care for the elderly) is likely to explode. By the nonpartisan Congressional Budget Office's reckoning, spending on those three programs alone is expected to reach 18 percent of GDP in the year 2040. That is the average level of revenues, measured as a portion of GDP, that the federal government has collected over the past 50 years. So, in this scenario, there would be nothing left to pay for everything from defense to interest on the debt. Thus, unless those entitlement programs (and other spending) can be drastically curtailed or taxes raised significantly, large and growing deficits are a certainty.
>
> But the auguries aren't good. Both political parties have become advocates of low taxes. President Obama's State of the Union address was a veritable panegyric to the virtues of tax cuts (although he is willing to raise taxes a bit for the rich in general, and rich bankers in particular). And now that Republicans have become defenders of spending every last dollar that Medicare recipients are currently promised, the prospect of reining in entitlement programs seems more remote than ever.
>
> In a politics-as-usual scenario, with no changes in the current policy of low taxes and unrestrained entitlement growth, the federal debt is projected to reach 100 percent of GDP by 2023. By 2038, it would reach 200 percent of GDP.

I'll close on this subject with some even more pessimistic words from Bill Julian:

> Add to the debt woes of European nations and US states the unfunded liabilities of the US government ($30 to $50 trillion, depending on who you ask) the bearded nationalization of the largest financial institutions in the world, Fannie and Freddy, and you have to ask, how could it have gotten this bad?
>
> . . . conditions of instability could reappear [quickly]. And this time, the crisis will center on government debt and the bond markets. The collectivist impulse spawned by Keynes as a solution to fiscal problems brought on by the bad behavior of the banks and the governments who cover for them will have gone as far as they can. There will be no one left to bail out "the system." The US government will be left with a nasty choice: austerity and fiscal discipline, or monetizing the debt [through devaluation or hyperinflation] and face a likely collapse of the bond market.

The bottom line appears to be that the U.S. must anticipate austerity, higher taxes, and the sluggish growth that combination is likely to produce. Failing that, we may face devaluation, default and other unthinkable developments. We are not exempt from the problems besetting Greece, or the awakening regarding the notions listed on page 5.

The State of the States

Many professional investors include *What I Learned This Week* from 13D Research among their highest-priority reading. Its discussions are big-picture and almost academic, but Kiril Sokoloff seems more likely than most to cover the big market-movers of tomorrow. He discussed the financial condition of the states in his June 24 issue, and I can't resist quoting extensively (I could give you more, but there has to be a limit):

> Across the U.S., state governments are on the edge of fiscal calamity . . . Last month, a report from the U.S. Center on Budget and Policy Priorities issued estimates that in fiscal 2010 the U.S. states collectively posted a near $200 billion budget shortfall, equivalent to 30% of all state budgets. As *Time*'s David von Drehle recently observed: *"Such persistent budget woes are unparalleled in the era of modern American government. You'd have to go back to the 1930s to find a parallel."*
>
> **After plunging in 2009, tax revenues are starting to stabilize in some places**, but revenues are still far off pre-recession levels. Collection of sales, personal-income and corporate taxes – which constitute 80% of state revenue – slumped 12% over the past two years. Meanwhile, fixed costs continue to keep states deep in the red.
>
> As would be expected, state and local governments have begun to take some much-needed steps – cutting costs, trimming pension eligibility, and depleting their rainy-day funds. In fiscal 2010, forty-five states reduced services to residents and over 30 states have raised taxes, in some cases significantly, according to the Center on Budget and Policy Priorities. **Fourteen states are expected to have reserves of less than 1% of their annual spending by the end of fiscal 2010 – they are basically living hand-to-mouth. . . .**
>
> But **the states, it must be remembered, have a large number of fixed costs, which continue to expand.** In addition to soaring pension obligations, the federal government has pushed a lot of its burdens onto the states, beginning with the sprawling mess that is Medicaid. Created by Congress, administered by the states, and funded by a mishmash of state, local and federal funds, *the healthcare system for America's poor is a train wreck waiting to happen.*
>
> **Medicaid spending, which accounted for 21% of state general fund expenditures in 2009, rose 6.6% that year and is expected to rise 10.5% in fiscal 2010,** according to Linda Bilmes, a professor at the Harvard Kennedy School. But while the number of enrollees increases, funding for the system will barely budge. As Arizona's Governor Jan Brewer said in her state-of-the-state

> address this year: “Government revenues have sagged to 2004 levels and some people say we should just adopt the 2004 budget” – easier said than done when your state’s Medicaid rolls have grown by nearly half a million since then. . . .
>
> **The states, like the federal government, are facing a demographic headwind that will continue to shrink their tax revenues and compound their growing social safety net obligations.** As Graham-Fisher’s Josh Rosner reminds us, the baby boomer’s peak earnings potential is behind them:
>
>> *These boomers are now moving to become the largest tax on the social safety net. The largest generation in U.S. history will retire with less equity in what has historically been the largest retirement and intergenerational wealth transfer asset for most families – their homes.* ***In many cases, these people will have no new*** [sic] ***personal savings when they reach the end of their working lives and will essentially become wards of the state.*** *This increased burden on the U.S. Treasury, in a decade, is the largest unconsidered impact of the current crisis.*
>
> Last year, the states’ fiscal woes were partly assuaged by the federal stimulus package. But nearly 70% of the $787 billion of stimulus funds approved early last year will have been spent by September, according to the CBO. (And while the emergency cash infusion helped the states keep their heads above water, it ultimately compounded their plight, since even though the federal funds are not necessarily recurring, the jobs and obligations they fund are.) This year, however, **the federal stimulus money is going to be thinned dramatically.**
>
> The Obama administration has asked for about $50 billion for 2011, but *experts believe it would require another $160 billion in cash just to meet demands for the next two years.* And this assumes there is no increase in unemployment or decrease in tax revenues. Even though there is scant appetite among election-susceptible Democrats in Washington to add more zeroes to the end of the federal deficit, there may be no alternative. If the federal government does not intervene, the entire U.S. economy could be put at risk. **After all, aren’t California and Illinois, like the country’s banks, “too big to fail”?** (Emphasis in the original)

I touched on the subject of the states’ fiscal condition in “Tell Me I’m Wrong” (January 22); that and the passages above from Sokoloff’s piece should suffice for now. However, I do want to go into a bit more detail regarding one of the key contributors to Greece’s troubles: pensions.

Pension promises have long been used in the U.S. as a budgetary quick fix. As in some parts of the private sector (see auto companies and “legacy” airlines), the public sector has a history of substituting sweetened pension benefits (and retiree medical benefits) for higher wages in the here-and-now, a prime example of “kicking the can down the road.” Employees bargained for promises of enhanced retirement payments in exchange for agreeing to limit increases in current compensation, but the cost of keeping those promises will be high and, as of today, is far from fully funded.

The Pew Center on the States estimates that as of June 30, 2008, the states had set aside $1 trillion less than would be needed to pay future pensions and medical benefits. On July 6, *The New York Times* reported on a study by Joshua Rauh of the Kellogg School of Management: ". . . assuming states make contributions at recent rates and . . . earn 8 percent, 20 states will run out of cash by 2025; Illinois, the first, will run dry in 2018. . . . Illinois, once its funds were depleted, would be forced to devote a third of its budget to retirees; Ohio fully half."

States such as California and Illinois clearly have debts that will be hard to pay and budgets that will be hard to balance. Fractious politics, the requirement for super-majorities on tax and budget matters, and the role (in my state) of referenda all render solutions elusive. **Will there be a bailout?** This is a great question to start thinking about today (although the prevailing ethic is to not worry about anything until doing so is absolutely unavoidable).

I have no doubt that the federal government wants to avoid a bailout at all costs, and that the rhetoric will remain staunchly anti-rescue. But when push comes to shove, I sincerely doubt a state will be permitted to go bankrupt. As Warren Buffett said at this year's Berkshire Hathaway annual meeting, "I personally think it would be very hard, in the end, for the federal government to turn away a state that is having extreme financial difficulties." (*Financial Times*, May 4)

Just as the E.U. doesn't want to give deficit spending a green light, fiscally responsible states don't want to pay debts that others created through overspending. **If the federal government were to bail out a defaulting state, what would keep any state from running deficits, knowing they could count on others to pay off their debts? When overspending isn't punished, what is there to discourage it? What better example is there of moral hazard?** Wouldn't it actually be irrational for a state politician to vote to deny his constituents a benefit if he knew the tab eventually would be picked up by others?

And by the way, like Europe, the U.S. has its own differences. Certain regions will be asked to foot the bill for others in a federal bailout. And certainly some states have been more "expansive" than others and have run up bigger debts. All just like in Europe. In the same way that Germans may be hesitant to bail out free-spending Greece, Texans may think twice about bailing out California, and North Dakotans may have doubts about New York. "Red" states are unlikely to leap to help struggling "blue" states given the Republican view that Democrats over-expand the role of government.

*　　*　　*

Experience shows how radically markets fluctuate between seeing the proverbial glass half full and seeing it half empty. Rather than achieve a happy medium, sometimes the markets focus exclusively on good news (as during the twelve months through April) and sometimes exclusively on bad. Greece kicked off a turn to the negative in late April, which was exacerbated by the Gulf oil spill and rising concern over the possibility of an economic double dip. On May 8, after Greece's troubles blossomed, *The New York Times* quoted Bill Gross as saying, "Up until last week there was this confidence that nothing could upset the apple cart as long as the economy and jobs growth was positive. Now, fear is back in play."

Just a few months ago, no one seemed to have a problem with nations that ran chronic deficits and continuously increased their debt. Then investors changed their mind – as they tend to do – and today they take a dim view of these practices. Government solvency is considered a critical issue. Here's how guest contributor and hedge fund analyst Andrew Marks (also my son) sums up current sentiment:

> Sovereign debt has become like fiat currency, as it is supported only by people's willingness to believe in other people's willingness to refinance it. The debt of an issuer with no plan to repay and no underlying way to meet maturities other than through refinancing sounds eerily like a subprime mortgage.

Markets are safer when fear balances greed, and when worry about losing money balances worry about missing opportunity. We don't like it when fear rears its head and stocks drop, but certainly that creates a healthier environment in which to be a holder, and one which should offer better buying opportunities. **Over the first part of this year it was easy to say prices had gotten ahead of fundamentals; all things being equal, that now seems less true.**

The current positives for investors include moderate valuations, rising corporate earnings and the likelihood we're already in a recovery. On the other hand, I continue to feel consumers are too traumatized to resume spending strongly, and I see unpleasant and rarely contemplated long-term possibilities including those discussed above. In particular, conservatism, austerity and increased savings are good for economic units individually but bad for a stagnant overall economy. **Bottom line: anyone who invests today in a pro-risk fashion out of belief in the recovery must be confident he'll be agile enough to take profits before the long-term realities set in.**

I've had a heck of a time pulling together all of these ideas, and I've found it even harder to come up with anything like answers. But I hope the discussion has been helpful, and that you'll think about the questions I've raised and encourage others to do so as well. **I don't enjoy feeling like a worrywart, but I doubt my concerns are unfounded, and I can't imagine silence would be preferable.**

July 19, 2010

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Memo to: Oaktree Clients

From: Howard Marks

Re: Hemlines

While the details change, the pendulum-like fluctuation of investment styles is a constant. Fear versus greed, pursuit of safety versus aggressiveness, stocks versus bonds, and growth versus value are just a few examples of the areas in which we see this take place. In this way, the investment world proves the wisdom of Mark Twain's observation that, "History doesn't repeat itself, but it does rhyme."

The limits of the pendulum's swing are fixed, and it tends to move back and forth over the territory between them. This occurs because (a) people tend to take trends to extremes, (b) neither extreme of the pendulum's arc represents a perfect or permanent solution, and (c) there's no place else to go in these regards. **Thus the best way to view investment trends may be through an analogy to hemlines: all they can do is go up and down, and so they do**. The style mavens call for short skirts, and people fall into line, raising hemlines until they're as high as they can go. And then they drop (and so forth).

The reasons behind the rise and fall of investment fashions rarely repeat exactly, in that the details, timing and effects vary from instance to instance. But the underlying process is a recurring one. For example:

- An idea is born when an undervalued asset is discovered.
- Its undervaluation attracts attention, as do pioneering investors' early gains.
- Its popularity rises, attracting more and more adherents, even as undervaluation moves to fully valued.
- It turns into a mania or "bubble," and price becomes immaterial.
- Eventually, the last potential buyer becomes convinced and comes on board.
- With no one else left to convert to the trend, the bubble of overvaluation is ripe for bursting.
- When followers experience the first price declines, disillusionment sets in.
- One-time devotees flee en masse, and the bubble turns into a crash.

This cycle of discovery, mania and crash is best summed up by the most useful of all investment adages: **"What the wise man does in the beginning, the fool does in the end."** This memo will be about recurring patterns, the history of stocks and bonds as I know it, and the adage's applicability to that history.

A Brief History of Stocks

A significant milestone occurred in October 2008, attracting a lot of attention. For the first time in almost fifty years, it was reported, the dividend yield on the Standard and Poor's 500 stock index was equal to the yield to maturity on the U.S. 10-year Treasury Note. People knew this meant stocks had cheapened, but it took an understanding of history to grasp the real significance. **The truth is that stocks, like other investment media, tend to go in and out of style, and this was just one more example of the latter.**

Prior to the 1950s, common stocks were viewed as a speculative, inferior (i.e., junior) asset class. For that reason, stocks had to pay higher yields than bonds in order to attract buyers; of course a riskier asset should yield more. In fact, most states had laws restricting holdings of stocks in fiduciary portfolios. This attitude toward stocks largely traced from the speculative stock bubble in the 1920s – featuring high-margin buying, bucket shops and shoe shine boys sharing stock tips – which collapsed in the Crash of '29. Poor economic and market performance stretching from 1929 to the end of World War II further contributed to the skepticism toward stocks.

It was only after WW II that economic performance began to support optimism. Brokerage firms led by Merrill, Lynch, Pierce, Fenner and Smith trumpeted the merits of stocks. Equity investing became widespread, and "customers' men" in local brokerage offices delivered stock investing to a great many households: I remember my mother buying 10 shares of Columbia Gas and 15 shares of Chock Full of Nuts around 1959.

I also remember a brochure on "growth stock investing" that Merrill put out in the mid-1960s, touting the desirability of rapid earnings growth and the strength of companies like IBM, Xerox, Avon, Coke, Texas Instruments and Johnson & Johnson. This idea grew into "nifty-fifty" investing, a true mania adopted by many of the large banks, among others. Ballyhoo took over from logic – excitement from value-consciousness – and these growth stocks' prices reached 80 and 90 times earnings.

The nifty-fifty stocks were tested – and found wanting – when the tide went out in the 1970s. Prosperity shifted to recession. The Arab oil embargo, a period of strong cost-push, and self-reinforcing cost-of-living adjustments created hyperinflation to which few people saw a chance for an end. Those growth stock p/e ratios went from 80 or 90 to 8 or 9. And stocks, Wall Street and the general economy went through a truly dreary decade, culminating in a *BusinessWeek* cover story entitled "The Death of Equities," in August 1979. For evidence of the cyclicality of attitudes toward stocks, consider its final paragraph:

> Today, the old attitude of buying 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 fogies. The stock market is just not where the action is."

In the investment world, lows in sentiment usually coincide with lows in price, and the late Seventies were no exception. Because of the dreadful environment, you could buy an existing company in the stock market for less than it would cost to start one. I was fortunate to become a portfolio manager in mid-1978, and thus to benefit from the subsequent recovery of investor psychology from its nadir.

In general (albeit with some prominent exceptions), the last half of the twentieth century was marked by the rise of a cult of equities, and the last quarter century was probably the best ever. From 1979 through 1990, the S&P 500 averaged an annual return of 15.4% and showed losses in only two years (4.8% in 1981 and 3.1% in 1990). Economic prosperity, rising corporate profits, a trend among consumers toward borrowing to spend, and the subsidence of inflation and interest rates all made for a most hospitable environment.

When the stock market's performance improved even further in 1991-99, with an average return of 20.6% and no down years, the fawning kicked up a notch. From the low of 7 reached in 1980, the p/e ratio on the S&P 500 eventually exceeded 33 in 1999. The market's dramatic performance led to steady increases in the capital allocated to equities, and eventually to the tech stock bubble. It culminated in books such as the fact-based *Stocks for the Long Run* and the more fanciful *Dow 36,000*. If you asked institutional investors what return they expected from stocks going forward, I think just about all would have said 11%.

An aside: investors consistently seize upon above average returns as an encouraging sign and extrapolate them, and the 17.6% compound return on the S&P 500 from 1979 through 1999 was certainly a case in point. But rarely do they ask what gave rise to those good returns, or what it implies for the future. In essence, stock ownership conveys the benefits of owning a corporation, and stock appreciation should be powered by increases in profits. Thus long-run returns should reflect corporate growth. But as Warren Buffett has pointed out, ". . . people get into trouble when they forget that in the long run, stocks won't appreciate faster than the growth in corporate profits." Although that growth is the underlying source of equity profits, it is often overshadowed and obscured in the short run by trends in valuation. People took that 17.6% gain as an encouraging sign, overlooking the fact that it stemmed primarily from the rise of p/e ratios described above and thus was unlikely to continue unabated. Rather than healthy performance that could be extrapolated, this swollen return should have come as a warning that valuations were unsustainable and likely to regress toward the mean. **But investors consistently fail to recognize that past above average returns don't imply future above average returns; rather they've probably borrowed from the future and thus imply below average returns ahead, or even losses.** The tendency on the part of investors toward gullibility rather than skepticism is an important reason why styles go to extremes.

Wharton's Professor Jeremy Siegel, the author of *Stocks for the Long Run*, used historical data (a) to demonstrate that there had never been a long period when stocks didn't outperform cash, bonds and inflation, and thus (b) to argue that most people of average risk tolerance should have roughly 100% of their capital in the stock market. But Siegel, like many laymen, failed to pursue the most critical line of inquiry. **The right question to ask in the late 1990s wasn't, "What has been the normal performance of stocks?" but rather "What has been the normal performance of stocks if purchased when the average p/e ratio is 33?"**

Many investors were seduced by the performance of stocks in the late 1990s by the promise of wealth and a secure retirement, and by the meshing of equity participation with the allure of the technology, media and telecom industries. The results are well known: the first three-year decline for stocks since the Great Depression; a peak-to-trough decline of 51% for the S&P 500; massive losses for tech investors; shrunken 401-k accounts; and general disillusionment with stocks.

Basically, I think equity investors had their hearts broken, as happens from time to time in the investment world. The promise of easy money turned out to be empty – as usual – and investors who had adopted overblown expectations promised "never again." A good economy, low interest rates and resurgent general psychology brought stocks back between 2002 and 2007, but just to their 2000 peak. Versus the 11% prospective return they were sure of in 1999, by 2003 many investors expected only 6-7% from stocks (despite the fact that they were now much cheaper). With the bloom off the rose, people looked elsewhere – to private equity, real estate, hedge funds and mortgage backed securities, for example – for the next solution. I didn't hear any investors say, "We don't have enough stocks." Their glory truly had faded.

But having recovered to their previous high, stocks were buffeted again in the credit crisis. They fell 58% from their 2007 peak to their 2009 trough. Stocks weren't singled out for punishment; non-government bonds, real estate, mortgage securities and private equity all shared the pain as panic and loss of confidence were everywhere.

With the panic now gone, stocks have recovered, but only about half their 2007-09 losses. The S&P 500 stands at a level that was first reached in 1998, meaning over the last twelve years, the average stockholder's paltry return of less than a percent a year came entirely from dividends. People talk about the "lost decade in equities," and still no one seems to feel he owns too few stocks.

A Brief History of Bonds

The recent history of bonds requires less telling. Bonds were the bedrock of investment portfolios in the first half of the last century. Along with Treasurys, utilities and corporates, business was brisk in railroad and streetcar bonds. Graham and Dodd's classic, *Security Analysis*, devoted more than 200 pages to "fixed-value investments" including preferred stock, of which next to nothing is heard today.

The story of bonds in the last sixty years is the mirror opposite of what happened to stocks. First bonds wilted as stocks monopolized the spotlight in the 1950s and '60s, and at the end of 1969, First National City Bank's weekly summary of bond data died with the heading "The Last Issue" boxed in black. Bonds were decimated in the high-interest-rate environment of the '70s, and even though interest rates declined steadily during the '80s and '90s, bonds didn't have a prayer of standing up to equities' dramatic gains.

By the time the late 1990s rolled around, any investment in bonds rather than stocks felt like an anchor restraining performance. I chaired the investment committee of a charity and watched as a sister organization in another city – which had suffered for years with an 80:20 bond/stock mix – shifted its allocation to 0:100. I imagined a typical institutional investor saying the following:

> We have a little money in bonds. I can't tell you why. It's an historical accident. My predecessor created it, but his reasons are lost in the past. Now our fixed income allocation is under review for reduction.

Even though interest in stocks remained low in the current decade, little money flowed to high grade bonds. The continued decline in bonds' popularity was fed, among other things, by the decision on the part of the Greenspan Fed to keep interest rates low to stimulate the economy and combat exogenous shocks (like the Y2K scare). With Treasurys and high grade bonds yielding 3-4%, they didn't do much for institutional investors trying for 8%.

As a result of a process I consider quite standard, bond allocations reached all-time lows at just the time they became needed. Other than cash and gold, Treasurys were the only asset that performed well in 2008. In fact, they benefited from a massive flight to quality. Corporate high grade and high yield bonds suffered along with everything else in 2008, but less than stocks, and they've enjoyed a comparable recovery. Thus bonds have performed much better than stocks since the onset of the crisis in July 2007, as shown on the next page.

	June 30 to June 30			
	2007-08	2008-09	2009-10	three years
10-year Treasury bond	12.6%	7.3%	8.3%	30.8%
Barclay's Govt/Credit	7.2	5.3	9.7	23.8
Citi High Yield Index	-0.5	-4.2	24.7	18.8
S&P 500	-13.1	-26.2	14.4	-26.6
MS EAFE Index	-22.5	-26.1	7.1	-38.7
MS Emerging Markets	2.6	-30.0	20.6	-13.4

Clearly, the recent performance edge of bonds over stocks has been dramatic.

What's Going On Today?

Now, suddenly, investors seem to have awakened to bonds' attractions. This after failing to do so in time for the crisis, when holding bonds would have been of great value. Is this just another case of investors driving while looking in the rearview mirror? And are they shifting from stocks to bonds at just the wrong time?

The headlines are dramatic and the facts are clear. In just the last few weeks, we've seen newspaper stories like these: "Investors Fleeing Stocks with Cash Flow Lure JP Morgan" (Bloomberg, August 16), "Treasury Bears Cave as Bond Yields Keep Tumbling" (*The Wall Street Journal*, August 16), and "Growing Concern over Bond Bubble" (*Financial Times*, August 21). Bloomberg reported as follows:

> About $33 billion flowed out of funds owning U.S. shares this year . . . About $185 billion was sent to bond funds through July 31, the most on record, according to the Investment Company Institute.

These statistics relate to mutual funds and their retail investors. While not necessarily the same for institutions, they are indicative of trends in investor psychology. In other words, the disaffection with stocks is continuing, and the withdrawn capital and much more is flowing to bonds. (It must be noted, however, as Tom Petruno of the *Los Angeles Times* pointed out on August 21, that <u>gross</u> inflows to equity mutual funds are still very substantial – and larger than those into bond funds – although exceeded in this period by outflows.)

The first question I want to tackle is "why these trends?" The answer with regard to stocks is simple. They were over-hyped in the 1990s; they disappointed in the 2000s; and investors are extrapolating the poor performance (even at lower prices) just like they previously extrapolated good performance (at higher prices). **This tendency to expect trends to continue is typical of investor behavior, especially with regard to phenomena that should instead be expected to regress toward the mean.**

In the late 1990s, when stocks were performing so well and universally expected to far exceed most investors' return needs, no one saw a reason to hold fixed income instruments with their modest yields. Now stocks have performed poorly for a decade and expectations have been cut back. Equities are no longer considered the sure thing they were. The other day *The New York Times* ran an article entitled "In Striking Shift, Investors Flee Stock Market":

> Renewed economic uncertainty is testing American's generation-long love affair with the stock market. . . . Small investors are "losing their appetite for risk." . . . "Like everyone else, I lost" during the recent market declines [an individual investor] said. I needed to have a more conservative allocation." . . . Investors pulled $19.1 billion from domestic equity funds in May, the largest outflow since the height of the financial crisis in October 2008. (August 22, 2010)

Turning conservative after a crisis smacks of closing the barn door after the horse has left, but it's a regular feature of investor psychology.

Of course, there has to be a fundamental rationale for investor behavior, and the current low opinion of stocks is based on the spreading belief that the recovery will be anemic and there could be a double dip. Also behind it may be the expectation that tax rates on dividends and long-term capital gains will rise relative to the rates on ordinary income.

And why is so much capital flowing to bonds? The analogy to hemlines serves well in this regard. Take a long-established style, stir in changed circumstances, and add a significant swing in psychology. **Bonds became passé over a long period of time, and stocks caught everyone's attention. When these trends had gone as far as they could, and the error of the fashion extreme ultimately was exposed, bonds came back into style.**

Bonds used to constitute the majority of portfolios; then a 70:30 equity/bond mix became the norm; and then bonds went further out of style. And then, when bond allocations got as small as they could, the style mavens began to call for more, instead. Of course it helped that bonds outperformed during and after the crisis.

So few people held bonds going into the crisis, and in such small amounts, that the attractions of bonds must seem like a sudden revelation: They're senior in the capitalization to equities, of course, so they're less subject to fundamental risk. Then there's what I call the "power of the coupon." In addition to redemption at maturity, most bonds provide an interest check every six months. Not only are these cash flows spendable and investable, but they also serve to stabilize bond prices, restraining volatility. Sounds like a great deal. So why, people now wonder, did we hold so few? **Take historically small allocations, add in newly discovered merits, and you get a buying trend and rising prices.**

The fundamental underpinnings for the buying trend in bonds are the converse of those compelling equity reductions: concern about economic sluggishness, the chance for a double dip, and even the distant possibility of deflation. Under any of these circumstances, companies are likely to do poorly, so you'd rather own senior securities (debt) with the promise of positive returns if held to maturity, rather than junior ones (equities), to which just about anything can happen.

And if inflation is declining – taking interest rates with it – you'd rather secure a fixed rate of return with a bond than hold a totally variable instrument like a stock. With inflation at zero or negative, the thinking goes, locking in today's interest rates will prove to have been a godsend.

Finally, if we get back into another crisis, wouldn't we rather hold bonds? Look how well they did during the last one.

At What Price?

That question – at what price? – isn't just the right question to ask about bonds versus stocks today. It's the right question regarding every investment at every point in time.

I try every chance I get to convince people that in investing, there's no such thing as a good idea . . . or a bad idea. Anything can be a good idea at one price and time, and a bad one at another. Here's how I've put it in the past:

> It has been demonstrated time and time again that no asset is so good that it can't become a bad investment if bought at too high a price. And there are few assets so bad that they can't be a good investment when bought cheap enough. . . No asset class or investment has the birthright of a high return. It's only attractive if it's priced right. ("The Most Important Thing," July 1, 2003)
>
> Investment success doesn't come primarily from "buying good things," but rather from "buying things well" (and the difference isn't just grammatical). ("The Realist's Creed," May 31, 2002)

The thing to think about isn't whether you'd rather have junior or senior securities in a recession, or fixed rate securities versus variable ones in deflation. The question is which securities are priced right for the future possibilities: which ones are priced to give good returns if things work out as expected and not lose a lot if they don't? You mustn't fixate on a security's intrinsic merits, but rather on how it's priced relative to those merits.

So, for example, it's not enough to say "We want fixed rate securities in deflationary times." You'll be glad to be holding 2½% ten-year Treasurys if deflation materializes, but how will you feel if it doesn't? And what's the probability of each outcome?

If bonds are ideal for deflation and stocks will bear the brunt of the associated economic weakness, is that all that matters? Would you rather buy overpriced bonds than underpriced stocks? Is there an objective standard for overpriced and underpriced? And, for example, if the ten-year note will pay 2½% regardless of the environment, and stocks will return 15% if deflation is avoided and lose 10% if it's not, doesn't deflation have to have a likelihood exceeding 50% for bonds to be preferred? (Check the math.)

My point here is that simplistic blanket statements are no help at all in making investment decisions. How have investors gotten killed in the past? By falling for statements like these:

- High-growth stocks are a good thing (1970).
- Bonds rated below triple-B aren't appropriate for investment (1977).
- No one will ever buy equities again (1979).
- There can never be too many disc-drive manufacturers (1988).
- The Internet and optical fiber will change the world (1999).
- Home prices can only go up, and there can't be a nationwide surge in mortgage defaults (2006).
- High yield bonds are unattractive given the risk of Armageddon (2008).

<u>**Most of today's positive articles about bonds are totally devoid of discussion of prices and probabilities. But it's only by assessing those things that attractiveness can be determined.**</u>

What To Do Now?

Ever since the financial crisis started in mid-2007, I've been saying any recovery would be lackluster and investors shouldn't be planning on prosperity. To me that called for investing in solid, stable, non-cyclical companies; avoiding levered companies and strategies; emphasizing risk-controlled strategies and managers; and, perhaps foremost, holding more bonds and fewer stocks. These were general principles: my own blanket statements, if you will. But now that stock prices have drifted lower and bond prices have continued to surge, I find I must reconsider the emphasis on bonds.

How are bonds priced today? What returns can we expect? Let's consider that 2½% ten-year note. With regard to Treasury securities, where it still seems safe to say there's no credit risk, there are three possible states of nature.

- If we buy at a yield to maturity of 2½% and interest rates don't change, we'll enjoy an annual return of 2½% per year for the next ten years. (With interest rates unchanged, there'll be no change in price other than from accretion to par at maturity, and we'll be able to reinvest the interest payments at the yields available at the time of purchase, an assumption implicit in the yield-to-maturity calculation.)

- If interest rates fall in response to economic weakness or deflation, we're likely to see interim appreciation. And if we sell at the appreciated prices, our holding-period return will exceed the yield to maturity at which we bought. Even if we just hold, our 2½% notes will be desirable museum pieces, as in, "Do you remember the good old days, when you could get 2½% on Treasurys?" (In truth, though, how much lower can yields go from here?).

- Finally, if the economy, inflation and interest rates surprise on the upside relative to today's low expectations, having locked in a yield of 2½% won't turn out to have been a good thing. From 2½%, it's clear that rates have much further to go up than down. Any substantial increase in bond yields would bring meaningful interim price declines. It must be borne in mind that holders of the bonds of creditworthy issuers don't have to worry about permanent capital losses (unless they're frightened into selling when things are down). A bond that's money-good will outlive any negative interim fluctuations, pay par at maturity and deliver the yield at which it was bought. So the real risk for people who invest in these bonds is that their returns turn out to be sub-par under the circumstances. If inflation turns out to be normal, investors in the 2½% note may end up with no more purchasing power down the road than they have today – that is, a real return of zero. Thus, if there are positive surprises in the environment, bond holders are likely to wish they had stocks instead.

Portfolio construction is supposed to strike an appropriate balance between safety and certainty on one hand and aggressiveness and gains-seeking on the other. The key question is whether today's bond buyers are leaning too heavily toward the former and forgetting too much about the latter. Are they too pessimistic and thus honoring uncertainty to excess?

An article by Richard Thaler of the University of Chicago, in *The New York Times* of August 22, makes an important point. He wrote about CFOs, but I think it's largely the same for investors:

> . . . the confidence limits [of their forecasts] widen after bear markets, mostly because estimates at the lower bound become more pessimistic. This puts a new light on the recent comment by Ben S. Bernanke . . . that the economic outlook was "unusually uncertain." . . . Yes, things *feel* more uncertain after bad times,

> but severe market downturns tend to occur after long bull markets when we are feeling least uncertain.

In other words, investors become so accustomed to good times that bad times seem unsettling in comparison. **That could explain excessive appetites for the safety of bonds and thus why, according to Deutsche Bank, "the top 10 lowest-yielding U.S. corporate new issues in history have been sold in the last 14 months"** (Bloomberg, August 16).

And what about sellers of stocks? I'm no longer an "equity guy" by profession, and Oaktree manages far more bonds than stocks, so this isn't a commercial. But I feel investors may be overlooking some substantial merits on the part of stocks today (data from Bloomberg, August 16, except as noted):

- Having made their organizations lean and benefited from declining floating-rate interest costs, cheaper labor or staff downsizing, companies are doing a good job of making money despite today's lackluster economic environment. "Earnings for S&P 500 companies may rise 36% in 2010 and 16% in 2011, the largest two-year advance since 1994-5."

- Rather than spend that money on expansion or acquisitions, most companies are piling it up. "The Federal Reserve reported in June that nonfinancial companies were holding cash totaling more than $1.8 trillion, having built up their hoards at a rate unmatched in more than 50 years" (*LA Times*, August 25). This pile of cash adds greatly to companies' financial security and to the potential for dividend increases or stock buybacks in the future.

- Finally, those selling or shunning stocks today seem to be overlooking some very attractive valuation parameters.

  - Price/earnings ratios are lower than usual. "The S&P 500 trades at 14.4 times annual earnings, compared with an average of 16.5, according to data . . . that goes back to 1954." Not giveaway levels, but 13% below the post-war average.

  - Annual free cash flow for American companies excluding banks is running at 6.8% of their market value. This "cash flow yield" is roughly capable of being compared against the yield on bonds. Although (unlike dividends or interest) the cash flow isn't necessarily received by investors as it's earned, it should contribute to stocks' value one way or another.

The bottom line is that, as bond prices rise (reducing yields) and p/e ratios fall, the chances increase that stocks will outperform bonds. Thus the benefits high grade bond investors feel they're gaining through **what they're buying** can be undone by **what they're paying**. I'll say it another way: **the attractiveness of one investment relative to another doesn't come from what it's called or how it's positioned in the capital structure, but largely from how it's priced relative to the other.**

I'm impressed today by the ability to assemble a portfolio of iconic, high quality, large-cap U.S. growth stocks that will provide appreciation in a strong environment, a measure of protection in a weak environment, and a meaningful dividend yield regardless. To me, and given my standard view that we don't know what the macro future holds, these stocks' potential over a range of possible scenarios is more attractive than bonds which will do well in periods of economic weakness or deflation but poorly in strength or inflation.

Compared to stocks, I feel Treasurys and high grade bonds currently reflect all of the environmental factors in their favor and perhaps more and are priced rich relative to stocks. For them to do well from here, with yields so low, everything has to work out as the bond bulls hope.

My friend, hedge fund manager Doug Kass, publishes a daily note to investors. (Given that I average a memo every couple of months, I find the very idea daunting.) I usually like what he writes, which is another way of saying we think a lot alike. Doug's August 18 note carried a catchy headline, "Setting Up For the Trade of the Decade." His nominee for that sobriquet: shorting the U.S. bond market.

What about high yield bonds, one of Oaktree's flagship asset classes? They're selling at yield spreads over Treasurys that are well above the historic norms, and their promised yields to maturity (before credit losses) should help institutional investors toward their return goals. On the other hand, it must be said that if interest rates rise, high yield bonds will see interim markdowns (albeit cushioned by their modest durations and the "gravitational pull" of price toward par at maturity). In all, given today's yield spreads, we believe high yield bonds will outperform high grade bonds in most foreseeable long-term environments.

Leveraged loans may deserve consideration as well. The yields on these loans are low in the absolute, like other fixed income instruments, but relatively attractive at 5½-6%. The loans are senior-most in the capital structure, meaning they should provide some protection in a sluggish economy, and the fact that their interest rates float with LIBOR should insulate them against interest rate increases.

Oaktree manages half a dozen large "multi-strategy fixed income" accounts, in which we are responsible for allocating capital to our various marketable securities strategies. Recently, in recognition of the developments described above, we made a modest initial shift away from high yield bonds and into convertibles, with their sensitivity to equity market trends. Here's what I wrote to our multi-strategy clients a month ago:

> Certainly by the onset of 2000, people believed too much in stocks and thought too little of bonds. Now, a decade later, these things are reversing. As we enjoy our portfolios' performance, we should be alert for a day when bonds will have become too popular and stocks' outcast status will have rendered them too cheap. We can pat ourselves on the back for being in the right asset classes today, but we shouldn't fail to consider what these diverging performance trends can do to tomorrow's returns.

Since few investment trends continue forever, it's usually smarter to expect ultimate regression to the mean rather than growth to the sky. No one should view the great popularity of bonds relative to stocks without reservation.

September 10, 2010

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Memo to: Oaktree Clients

From: Howard Marks

Re: Open and Shut

Mark Twain is described as having said, "History doesn't repeat itself, but it does rhyme." Thanks to the tendency of investors to forget lessons and repeat behavior, it sometimes seems there's no longer a need for me to come up with new ideas for these memos. Rather, all I have to do is recycle components from previous memos, like a builder reusing elements from old houses. I'm willing to try an experiment along those lines for this memo. Here are my building blocks:

From "First Quarter Performance," April 11, 1991:

> The mood swings of the securities markets resemble the movement of a pendulum. Although the midpoint of its arc best describes the location of the pendulum "on average," it actually spends very little of its time there. . . . This oscillation is one of the most dependable features of the investment world, and investor psychology seems to spend much more time at the extremes than it does at the "happy medium."

From "The Happy Medium," July 21, 2004:

> The capital market oscillates between wide open and slammed shut. It creates the potential for eventual bargain investments when it provides capital to companies that shouldn't get it, and it turns that potential into reality when it pulls the rug out from under those companies by refusing them further financing. It always has, and it always will.

From "You Can't Predict. You Can Prepare." November 20, 2001:

> Overpermissive providers of capital frequently aid and abet financial bubbles. . . . In *Field of Dreams*, Kevin Costner was told, "if you build it, they will come." In the financial world, if you offer cheap money, they will borrow, buy and build – often without discipline, and with very negative consequences.

From "Genius Isn't Enough," October 9, 1998:

> Look around the next time there's a crisis; you'll probably find a lender.

The above citations provide the themes for this memo. I'll just update them, put them into the current context and discuss the ramifications for investing today. We'll see how it goes. If it works well this time, readers may conclude that in the future they can fashion their own memos from bits and pieces of my old ones.

<u>The Credit Cycle at Work</u>

Consider this: the ups and downs of economies are usually blamed for fluctuations in corporate profits, and fluctuations in profits for the rise and fall of securities markets. However, in recessions and recoveries, economic growth usually deviates from its trendline rate by only a few percentage points. Why, then, do corporate profits increase and decrease so much more? The answer lies in things like financial leverage and operating leverage, which magnify the impact on profits of rising and falling revenues.

And if profits fluctuate this way – more than GDP, but still relatively moderately – why is it that securities markets soar and collapse so dramatically? I attribute this to fluctuations in psychology and, in particular, to the profound influence of psychology on the availability of capital.

In short, whereas economies fluctuate a little and profits a fair bit, the credit window opens wide and then slams shut . . . thus the title of this memo. I believe the credit cycle is the most volatile of the cycles and has the greatest impact. Thus it deserves a great deal of attention.

In "The Happy Medium," I discussed the workings of the credit cycle in creating market extremes:

> Looking for the cause of a market extreme usually requires rewinding the videotape of the credit cycle a few months or years. Most raging bull markets are abetted by an upsurge in the willingness to provide capital, usually imprudently. Likewise, most collapses are preceded by a wholesale refusal to finance certain companies, industries, or the entire gamut of would-be borrowers.

Then, in "You Can't Predict. You Can Prepare." I described this expand-and-contract process in detail, along with its ramifications:

- The economy moves into a period of prosperity.
- Providers of capital thrive, increasing their capital base.
- Because bad news is scarce, the risks entailed in lending and investing seem to have shrunk.
- Risk averseness disappears.
- Financial institutions move to expand their businesses – that is, to provide more capital.
- They compete for share by lowering demanded returns (e.g., cutting interest rates), lowering credit standards, providing more capital for a given transaction, and easing covenants.

When this point is reached, the up-leg described above is reversed.

- Losses cause lenders to become discouraged and shy away.
- Risk averseness rises, and with it, interest rates, credit restrictions and covenant requirements.
- Less capital is made available – and at the trough of the cycle, only to the most qualified of borrowers, if anyone.
- Companies become starved for capital. Borrowers are unable to roll over their debts, leading to defaults and bankruptcies.
- This process contributes to and reinforces the economic contraction.

Of course, at the extreme the process is ready to be reversed again. Because the competition to make loans or investments is low, high returns can be demanded along with high creditworthiness. Contrarians who commit capital at this point have a shot at high returns, and those tempting potential returns begin to draw in capital. In this way, a recovery begins to be fueled. . . .

Prosperity brings expanded lending, which leads to unwise lending, which produces large losses, which makes lenders stop lending, which ends prosperity, and on and on.

The bottom line is that the willingness of potential providers of capital to make it available on any given day fluctuates violently, with a profound impact on the economy and the markets. There's no doubt that the recent credit crisis was as bad as it was because the credit markets froze up and capital became unavailable other than from governments.

<u>Impact of the Credit Cycle</u>

The section above describes how the capital cycle functions. My goal below is to describe its effect.

From time to time, providers of capital simply turn the spigot on or off – as in so many things, to excess. There are times when anyone can get any amount of capital for any purpose, and times when even the most deserving borrowers can't access reasonable amounts for worthwhile projects. The behavior of the capital markets is a great indicator of where we stand in terms of psychology and a great contributor to the supply of investment bargains. **(**"The Happy Medium")

An uptight capital market usually stems from, leads to or connotes things like these:

- Fear of losing money.
- Heightened risk aversion and skepticism.
- Unwillingness to lend and invest regardless of merit.
- Shortages of capital everywhere.
- Economic contraction and difficulty refinancing debt.
- Defaults, bankruptcies and restructurings.
- Low asset prices, high potential returns, low risk and excessive risk premiums.

On the other hand, a generous capital market is usually associated with the following:

- Fear of missing out on profitable opportunities.
- Reduced risk aversion and skepticism (and, accordingly, reduced due diligence).
- Too much money chasing too few deals.
- Willingness to buy securities in increased quantity.
- Willingness to buy securities of reduced quality.
- High asset prices, low prospective returns, high risk and skimpy risk premiums.

The point about the quality of new issue securities in a wide-open capital market deserves particular attention. A decrease in risk aversion and skepticism – and increased focus on making sure opportunities aren't missed rather than on avoiding losses – makes investors open to a greater quantity of issuance. The same factors make investors willing to buy issues of lower quality.

When the credit cycle is in its expansion phase, the statistics on new issuance make clear that investors are buying new issues in greater amounts. But the acceptance of securities of lower quality is a bit more subtle. While there are credit ratings and covenants to look at, it can take effort and inference to understand the significance of these things. In feeding frenzies caused by excess availability of funds, recognizing and resisting this trend seems to be beyond the majority of market participants. This is one of the many reasons why the aftermath of an overly generous capital market includes losses, economic contraction and a subsequent unwillingness to lend.

The bottom line of all of the above is that generous credit markets usually are associated with elevated asset prices and subsequent losses, while credit crunches produce bargain-basement prices and great profit opportunities.

<u>The Events of the Past Decade</u>

The last several years have provided a typical example of the credit cycle at work – typical in its pattern, that is, but unique in its extent and impact.

The highs in risk tolerance, credulity, financial innovation and leverage seen between 2004 and early 2007 gave rise to a credit crunch in late 2007 and 2008 – the

greatest of our lifetimes – and to vast capital destruction. Structured and levered investment vehicles melted down, bringing unprecedented losses to those who had provided their capital, and forcing the sale of holdings regardless of price. Financial institutions flirted with potential insolvency, requiring their capital to be rebuilt via government programs. Money market funds and commercial paper had to be buoyed as well. Lehman Brothers went under. General Motors and Chrysler went bankrupt and required bailouts, and companies such as Fannie Mae, Freddie Mac, Merrill Lynch and Bear Stearns had to be supported or absorbed. All of this stemmed in large part from the too-easy availability of capital and from market participants' irresponsible behavior in the middle of the decade. The result was a massive flight to quality and widespread refusal to take risk.

In 2009, miraculously in my opinion, the responses of governments caused investor psychology to turn positive, and the pursuit of return caused risk tolerance to be restored. Risk capital became available again, enabling financial institutions to raise equity capital and highly indebted companies to access the capital markets, extending maturities and capturing the discounts on their debt. As a result – thanks to the rise in risk appetites – many markets showed their greatest gains ever.

This year, even though economic and geopolitical fundamentals are still shaky and new things to worry about arise from time to time, the credit markets are generally wide open for companies deemed to have critical mass. In "Warning Flags" in May, I observed that certain types of deals could be completed that exemplified behavior in the most heated pre-crisis days but had become impossible in late 2007 and 2008. These included issuance of CCC-rated, covenant-lite and payment-in-kind bonds; dividend recap transactions; and the organization of structured entities for investing in debt.

Recently there have been additions to that list:

- The issuance of 100-year bonds.
- The issuance of 50-year bonds callable in five years (if interest rates go up, the buyer will be stuck with a low-rate bond, but if interest rates go down, the issuer can quickly replace the bond with one bearing a lower rate).
- The issuance of inflation-adjusted Treasury Inflation-Protected Securities (TIPS) that will return minus 0.55% plus the rate of inflation (if there's no inflation, the return will be negative, and if the rate of inflation is positive, the yield on the TIPS will be below that rate).
- The issuance of bonds through so-called "drive-by deals." When a deal is announced in the afternoon and priced the next morning, investors have little time to study its creditworthiness and covenants.

Each of these things is indicative of the following on the part of investors:

- **rising confidence and declining risk aversion,**
- **emphasis on potential return rather than risk, and**
- **willingness to buy securities of declining quality.**

Why These Developments?

As with any economic event, there are numerous explanations for these things. But the one I want to concentrate on is government stimulus.

In the depths of the credit crisis, governments around the world took steps to deal with the liquidity contraction, economic slowdown and banks' depleted capital accounts. These included reductions of interest rates to record lows. The motivations and effects are many and varied.

First, everyone knows it's the primary goal of rate cuts to stimulate economic activity by making it cheaper and thus more attractive for businesses to borrow money with which to invest in factories, capital good and inventories. Retail credit should be cheaper, too, encouraging consumers to borrow and buy.

Second, providing low cost borrowings is a way to rebuild the health of financial institutions. If a bank can borrow $100 million from the central bank at 1% and lend it out at 6%, it's as though the government gave it $5 million per year (assuming the loans turn out to be money-good). Thus, in addition to enhancing banks' profitability and equity, in principle this should lead to increased lending.

To date, the results in these areas have been mixed. Economic activity is still muted and lending is slow. But another by-product has become particularly pronounced: encouragement to take risk.

So third, Treasury bill rates near zero – and note yields of 1 or 2 percent (depending on which country we're talking about) **– have the effect of driving investors toward riskier investments**. Especially when fear and risk aversion recede, returns like these on Treasurys become unacceptable. Thus some money that otherwise would have been invested in the safe part of the fixed income market is forced to more aggressive places.

Whatever fundamental doubt – and resulting reticence – might exist is in part offset by the unacceptably low returns on the safest of investments. Thus, for example, people who wouldn't buy high yield bonds in the past at their traditional 12% yields, or at 20% in 2008, will buy them today at 7% primarily because they can't stomach Treasurys at 2%. In the same way, alternative investment categories that fared poorly in the crisis can attract equity capital again (albeit in smaller amounts and to be paired with less leverage).

The fourth impact is that interest rate declines cause asset appreciation. This restores wealth – household and otherwise – and with it the bullish feelings that give rise to increased willingness to spend money and bear risk.

Fifth, quantitative easing (QE) puts cash in investors' hands in exchange for the securities the Fed buys. This, too, should add to investors' appetite for investing.

However, a program such as QE that increases liquidity has additional consequences. For example, other countries are complaining that (a) excess capital from the low-rate U.S. will flood their markets, inflating asset and commodity prices, and (b) increasing the supply of money in the U.S. will weaken the dollar, unfairly strengthening the appeal of U.S. exports and reducing U.S. demand for imports.

<u>The Ramifications</u>

In 2003, my memo "What's Going On?" included a tortured metaphor called "The Cat, the Tree, the Carrot and the Stick." In low-return environments, I said, investors are forced to move further out on the risk curve because of the paltry returns available on safe investments, and lured to riskier investments by the higher returns promised there. Conscious risk bearing can be done responsibly and perhaps even profitably. **But low-return environments often lead investors to unconsciously reach for return, with results that are painful. One of our greatest imperatives is to be alert to the emergence of such behavior.**

A final reference to past memos: you might want to look back to 2004's "Risk and Return Today." It describes an investment environment in which rates on short-term Treasurys, reduced by the Fed, had brought down returns in the safe part of the capital market. As a result, I said, the capital market line was "low and flat," with inflated asset prices, low returns, skimpy risk premiums and high risk. I went on to urge caution when investing in such a low-return environment. It was early, but it turned out to have been in order.

There are differences today. Yield spreads on non-investment grade debt are above average. Leverage is only available in more moderate amounts. With investors chastened by cash squeezes in 2008, the flow of capital to private strategies is limited. Equity p/e ratios are below the historic average. And investors seem to be conscious of the economic and geopolitical uncertainties.

But there are also direct similarities, primarily in the fact that inadequate yields on Treasurys are driving bond investors elsewhere to apply their rekindled risk-taking, and thus absolute yields are low on all fixed income instruments.

On November 12, *The New York Times* reported on comments by Martin Feldstein, former president of the National Bureau of Economic Research and chairman of the Council of Economic Advisers under Ronald Reagan:

> Anticipation of QE2, he wrote in the *Financial Times*, caused prices of commodities and common stocks to rise.
>
> "Like all bubbles, these exaggerated increases can rapidly reverse when interest rates return to normal levels," he said. "The greatest danger will then be to leveraged investors, including individuals who bought these assets with borrowed money and banks that hold long-term securities.

> These risks should be clear after the recent crisis driven by the bursting of asset price bubbles. **Although the specific asset prices that are now rising are different from last time, the possibility of damaging declines when bubbles burst is worryingly similar**." (Emphasis added)

In 2006-07, the most appreciated assets were real estate, mortgages and buyout companies. This year they're Treasury securities around the world, gold, commodities, currencies (versus the U.S. dollar), and real estate and stocks in emerging markets. Buyout companies could return to the list due to the combination of cheap debt, equity capital needing investing, and strong competition to put it to work.

The bottom line is that for whatever the reason, some asset prices have risen again, risk bearing has returned, and the risky transactions of 2004-07 are once again doable. Thus it strikes me that it's time to dust off the ultimate piece of advice from Warren Buffett:

> **The less prudence with which others conduct their affairs, the greater prudence with which we must conduct our own affairs.**

Investors who engaged in aggressive behavior just a few years ago experienced significant pain as a result. Perhaps the punishment was too brief, and perhaps it was reversed too soon. Thus some are acting aggressively once again. It's possible that such behavior won't be punished again the second time around, but prudent investors shouldn't take the risk.

At the depths of the markets in the fourth quarter of 2008, after Lehman Brothers' bankruptcy filing and other events had unnerved the world, great assets were on sale at irrationally low prices. The result – as always in crashes – was that high prospective returns were available with low attendant risk. Just two ingredients were required in order to take advantage: capital and the nerve to invest it.

Today some assets are fairly priced and others are high, but there are no bargains like those of 2008. Capital and nerve can't hold the answers in such an environment. We're no longer in a high-return, low-risk market, especially in light of the inability to know how today's many macro uncertainties will be resolved. **Instead of capital and nerve, then, the indispensable elements are now risk control, selectivity, discernment, discipline and patience.**

December 1, 2010

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Memo to: Oaktree Clients

From: Howard Marks

Re: All That Glitters

In 1952, Noah S. "Soggy" Sweat, Jr., a member of the Mississippi House of Representatives, was asked about his position on whiskey. Here's how he answered:

> If you mean whiskey, the devil's brew, the poison scourge, the bloody monster that defiles innocence, dethrones reason, destroys the home, creates misery and poverty, yea, literally takes the bread from the mouths of little children; if you mean that evil drink that topples Christian men and women from the pinnacles of righteous and gracious living into the bottomless pit of degradation, shame, despair, helplessness, and hopelessness, then, my friend, I am opposed to it with every fiber of my being.
>
> However, if by whiskey you mean the oil of conversation, the philosophic wine, the elixir of life, the ale that is consumed when good fellows get together, that puts a song in their hearts and the warm glow of contentment in their eyes; if you mean Christmas cheer, the stimulating sip that puts a little spring in the step of an elderly gentleman on a frosty morning; if you mean that drink that enables man to magnify his joy, and to forget life's great tragedies and heartbreaks and sorrow; if you mean that drink the sale of which pours into our treasuries untold millions of dollars each year, that provides tender care for our little crippled children, our blind, our deaf, our dumb, our pitifully aged and infirm, to build the finest highways, hospitals, universities, and community colleges in this nation, then my friend, I am absolutely, unequivocally in favor of it.
>
> This is my position, and as always, I refuse to compromise on matters of principle.

Sweat's response shows, depending on how you look at it, either how views can diverge on a given subject or how differently a tale can be spun. Thus it serves well to introduce the topic of this memo: gold.

Before the global financial crisis, most participants in the world of finance felt they understood how things worked, and that in addition to the underlying processes, they could rely on institutions and currencies.

Then the crisis occurred and a lot changed. Things happened during the crisis that were described as "five-standard-deviation occurrences" (or three or eight). In other words, things happened that had never happened before and had been considered capable of happening only once in several generations or centuries. But they happened, and sometimes a few in a single week.

These were negative "black swan" developments, and they had a number of ramifications. First, they imposed substantial losses. Second, they called into question the predictability and understandability of the financial world and introduced new levels of uncertainty. And third, they set off a search for things that would provide certainty and safety in the newly uncertain world. This search led many to look to gold.

On the Merits of Gold

I have no doubt: gold is the ideal investment. It serves as a reliable store of value, especially in challenging and uncertain times. It's a hedge against inflation, since its price rises in sympathy with the general level of prices. It exists without the involvement of man-made constructs such as governments. And it's desired and accepted all around the world (and always has been).

The supply of gold is finite. It can't be created out of thin air. Thus it's not subject to dilution or debasement, as is paper currency when governments decide to print more. In comparison, currency can be similarly reliable only if backed by gold.

Finally, gold is tangible, meaning you can take delivery and store it. Most other investment media exist only in the form of figures on a computer screen. But gold is something you can actually hold and know you own. Thus it's one of the few things you can depend on in an uncertain world. Gold is perfect.

Except, of course, gold is nothing but a shiny metal. Since its real-world applications are limited to jewelry and electronics, very little of its value comes from actual usefulness. Further, the amount put to those uses each year is small compared to the total amount in existence, so its value for those purposes is at the margin and can't be of much help in putting a price on the world's gold reserves.

There's little intrinsic to gold that enables it to serve as a store of value and a hedge against inflation. Gold serves those purposes only because people impute to it the ability to do so. It's self-deception, nothing but the object of mass hysteria like that exhibited in "The Emperor's New Clothes." **Gold has no financial value other than that which people accord it, and thus it should have no role in a serious investment program. Of this I'm certain.**

A Never-Ending Argument

The foregoing aren't my views, of course. Rather, they're my effort to summarize the prevailing – and obviously polar – points of view regarding gold. I think gold engenders attitudes that are the furthest apart of those regarding any potential investment. The "gold bugs" think it's ideal and dependable, and the naysayers think it's unanalyzable and anachronistic.

Due to the trauma and uncertainty introduced by the financial crisis, the subject of gold has attracted increased attention and the debate has heated up. It has doubled in price over roughly the last two years. And I've been asked about gold more in those two years than in all the rest put together.

I didn't think about gold very much during my first 39 years in the money management business. First I was an equity guy, and then I became a bond guy. I never had a client who held gold (as far as I knew) and no one asked for my views on it. In a world in which people thought they knew how things worked and everything went smoothly most of the time, gold was considered largely irrelevant.

For the last few years, I've advised a Swiss charitable foundation that, as is customary in its home country, holds substantial amounts of precious metals. Thus I've had to think about gold – which I never had to do before – and come to a conclusion.

My view is simple and starts with the observation that gold is a lot like religion. No one can prove that God exists . . . or that God doesn't exist. The believer can't convince the atheist, and the atheist can't convince the believer. It's incredibly simple: either you believe in God or you don't. **Well, that's exactly the way I think it is with gold. Either you're a believer or you're not.**

<u>My View</u>

In the past, the only thing I considered certain about gold was that I didn't have to consider it. But in the last few years, I did think (and write) on a subject very germane to gold: the valuation of non-income-producing assets.

Show me a company, security or property that produces a stream of cash, and I think I can value it reasonably accurately. P/E ratios, yields and capitalization rates give us a framework for valuing these things, and by comparing them to prevailing interest rates, to historic valuation parameters and to each other, we can assess whether an asset is dear or cheap.

But there's no analytical way, in my opinion, to value an asset that doesn't produce cash flow . . . and especially one that doesn't at least have the prospect of doing so. (What I mean by the latter is that it's more challenging to value an empty building than a rented one; or an empty lot compared to one with an office building on it; or a young company relative to an established, profitable one. But at least you can attempt to value the former asset in each case on the basis of its potential to produce cash flow.) How do you put a value on an asset that will never throw off cash?

Take oil, for example. As I wrote in "There They Go Again" (May 6, 2005), you can say the supply of oil is finite; that we're using it up faster than we're finding it; and that much of it is in the hands of nations we can't depend on. But what does that make it worth? You could have said those things in December 2008, when oil was $35 a barrel, and if you'd bought you'd be up 150% today. But they were equally true in July 2007, when oil was at $147, and if you bought you would have lost three-quarters of your money in six months. Qualitative statements like those simply cannot be converted into a price.

And how do you value a home? The appraisals that were relied on by mortgage lenders in 2002-07 obviously did more harm than good. All the appraisers did is compare each home to the last similar one that sold, and their work-product literally turned out not to be worth the paper it was printed on. You might value a home based on what it could be rented for, but today's vacancies show that you can find tenants for some houses but not all of them. No, the value of a home at a given point in time ultimately is just what a buyer will pay for it.

In fact, that's true of all non-income-producing assets: they're only worth what buyers will pay for them. You might say that about income-producing assets as well, given how their prices fluctuate, but that's completely true only in the short run and mostly when markets function poorly. If assets produce cash flow, that gives them value, and it's reasonable to believe that eventually their prices will move in the direction of that value. They aren't required to do so in any particular time frame, but that expectation provides the most solid basis there is for investing. **Everything else is mere conjecture by comparison, and that goes for gold.**

At What Price?

In "Hemlines" in September, I said investors were pursuing safety – simplistically, as they usually do the flavor of the day – but ignoring the price they were paying for it. I titled that section "At What Price?"

I'm reusing that heading here, because that's really the key question in investing. We all would prefer to have growth, quality, income and safety in our investments. But how much will we pay for them? **I've said it many times: no asset can be considered a good idea (or a bad idea) without reference to its price.** How can we evaluate whether the price of gold is right?

As with oil, you can list gold's attractions as enumerated on page two. But how do you turn them into a price? And don't you have to be able to turn them into a price in order to invest intelligently? Consider this conversation:

Howard: How do you feel about gold here at $1,400 an ounce?

Gold bug: Great. I'm sure it will hold its value from here and keep up with inflation.

Howard: Would you be equally sure if it were $2,000?

Gold bug: A little less, but yes.

Howard: At $5,000?

Gold bug: That's a tough one.

Howard: And at $10,000?

Gold bug: No; there it would be ahead of itself.

Howard: So the price of gold matters?

Gold bug: Sure.

Howard: Then how can you be sure it's fairly priced at $1,400?

Gold bug: Hmm . . . . .

The point is, in investing, price has to matter. Nothing can be a good buy solely on the basis of its attributes alone, without considering the value they give rise to and the relationship of price to that value. And there's no quantifiable value against which to compare price in the case of gold. There; that's it. Either you agree with those statements or you don't.

The gold bug's usual recourse to the difficulty in pricing gold is to point to a past price for the metal and how little it has appreciated since then. For example, gold hit a high of $850 in 1980 and has gained only 2% per year since then. The Leuthold Group is often quoted (e.g., *Reuters*, November 29) as observing that it would have to be at $2,400 today to merely equal the 1980 price in inflation-adjusted terms.

But those making a claim for gold's cheapness on the basis of comparisons against historic prices typically point to hand-selected observations, as in Leuthold's case. What about the fact that gold was $250 in mid-1999 (*Financial Times*, November 13), meaning it's been up 16% a year for the last decade-plus? And even if the snail-like appreciation from $850 in 1980 seems persuasive, how do we know gold was priced reasonably in 1980, and thus that the fact that it's low relative to 1980 makes it reasonable today? If gold was overpriced in the past, then even having failed to show much appreciation in the interim, it could still be overpriced today.

<u>In Gold We Trust</u>

In the 1970s I came across a book called *Money Is Love* by Richard Condon. I bought it because I had enjoyed *The Manchurian Candidate*, a 1962 movie based on another

Condon book. All I remember about *Money Is Love* is that it was set in a period when people were crazy about collectable plates and amassed them as a store of value. One person had so many that their weight made his apartment collapse into the one beneath it.

In the book, collectable plates had value for the simple reason that people felt they did. That sounds silly. But is gold any different? Are there better reasons for it to have value?

My point here is the one I've held longest on this topic: that gold works as a store of value solely because people agree it will. For years I've felt that there's nothing special about gold that makes it right for this role. It just happens to be the metal people began to lust after a few millennia ago. It could have been iron, but iron is too common and thus not special enough: it doesn't shine, and it rusts. It could have been platinum, but people couldn't find it, or enough of it for it to be popular. Perhaps the fact that gold got the job is just a coincidence.

But what about the other hand? (For thoughtful people, I think there's always another hand.) **Let's say we disrespect gold given that it has value only because people agree it does. What about the U.S. dollar?** Why do we accord the dollar value, or any other paper currency for that matter? It has value because the government says it does, and we go along. Sound familiar?

Forty years ago, you could turn in paper money and get an ounce of gold for each $35. Then President Nixon ended the convertibility of gold in 1971 and that was no longer possible. Now there's nothing behind the dollar but people's belief in it.

As an aside, when I was working on Wall Street for the first time in the summer of 1967, the government announced that it was going to terminate the convertibility of banknotes labeled "silver certificates." So I found a dozen or so in my wallet and took them to the Federal Assay Office on a nearby street called Old Slip. The clerk counted them, put the equivalent weights on one side of a huge balance scale, poured granulated silver onto the other side from a bag, and handed the silver to me in an envelope. I'm very glad that I still have it today, plus a few silver certificates that I didn't convert . . . plus the rest of my memories of those early days.

Wikipedia defines "fiat currency" as "state-issued money which is neither legally convertible to any other thing, nor fixed in value in terms of any objective standard." Today the non-convertible dollar (like most other currencies) is a fiat currency. Wikipedia goes on to say fiat currencies "lack intrinsic value."

So if I complain that gold lacks intrinsic value, perhaps my wariness should also make me question dollars (and euros, pound sterling and yen). If gold has the limitations I describe in this regard, what can we say about currencies? (Bruce Karsh goes on to raise a further conundrum: we may prefer income-producing assets, with their intrinsic value, to fiat currency. But the income they produce is reckoned in currency, and thus their value is as well. So, is the value of those assets any more "real" than currency? What does have real value? Maybe just things with actual usefulness and not just monetary value, like farms. It certainly does get complicated.)

We can talk about the fact that gold's value isn't intrinsic or quantifiable. But the question really comes down to whether people's faith in gold will increase or erode. Relevant here is a profound observation regarding markets from John Maynard Keynes.

In Keynes's time, a London newspaper ran photos of a large number of young women, with a prize going to the reader whose list of the five prettiest most closely paralleled the votes of all readers. The winning strategy wouldn't be to try to pick the prettiest contestants, but rather the ones most voters will say are the prettiest. In other words, one's contest submission shouldn't be based on intrinsic merit, but on guesses regarding the other participants' views of intrinsic merit. The same is true for investments, including gold. Thus it's not whether gold has value, but whether people will impute value to it.

But it goes further. Especially in the short run, the superior investor may not be the one who's right about the merit of something, or even the one who's right about the consensus view of merit. Rather, the superior investor may be the one who's right about the judgments other people will make about the consensus view of merit.

> It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees. (*General Theory of Employment Interest and Money*, 1936).

Will people continue to impute value to gold? Or will they bet that others will continue to impute value to gold? Those are the key questions. It's hard to predict change in these things, but it's the change that makes and eliminates fortunes.

<u>Gold in Times of Uncertainty</u>

In the last six weeks, in addition to North America, I have visited with clients and contacts in Europe, Asia, Australia and South America. **Perhaps the greatest common thread I detected was a sense that the world is more uncertain, and the range of possible outcomes wider, than ever before.** People who before the crisis felt they understood how economies and governments work – and thus what could be expected in the future – now feel very differently.

Today we're faced with uncertainty regarding a vast list of issues including:

- the outlook for economic growth,

- the ramifications of high debt levels and the necessary austerity measures,
- the economic future of the developed world,
- the impact of China and other emerging nations,
- the likelihood of deflation versus hyperinflation, and
- the soundness of currencies and sovereign debt.

Thus it shouldn't come as a surprise that people are groping for something they can depend on. **Since gold acts as a barometer of expectations regarding inflation and concern about economies and currencies, its popularity has risen as sentiment regarding these things has declined.**

Being away from home tends to alter one's perspective. While traveling, I was shocked to hear someone (okay, a gold producer possibly "talking his book") describe the U.S. as having a corrupt political system in the grip of special interests and being committed to the debasement of the dollar. While I know the stimulative actions being undertaken may well cause the dollar to weaken, I like to think the part about corruption isn't true.

But I have to admit that I'm not all that happy with what's going on in the U.S., and especially in Washington, D.C. (see "What Worries Me," August 2008 and "I'd Rather Be Wrong," March 2010). While other nations are enacting austerity measures to trim their deficits and debt, I don't see much coming from Washington. So if not corrupt, then perhaps just weak-kneed.

- The recent compromise tax "solution" is a good example (merits of the provisions aside): "I'll agree to continue the tax cuts and reduce estate tax rates for the wealthy (exacerbating the deficit) if you'll vote to extend unemployment benefits, cut payroll taxes and increase tax credits (exacerbating the deficit)." There's something for everyone in this bill, with its estimated cost of $858 billion over ten years. The only element missing from both sides' agendas is fiscal discipline.

- And what about the vote on the proposals from the President's commission on the deficit? While the appointed members of the commission generally backed them, they failed to get the needed supermajority because six of the ten elected officials who care about reelection voted no. These are tough issues, and by definition every possible solution will raise taxes or reduce government services. The fact is that most elected legislators seem unable to take any actions that might cost them votes.

Questions about the dollar are being raised worldwide. Thus an interesting result of being abroad is that **what looks like an increase in the dollar price of gold becomes easier to view as a decrease in the amount of gold a dollar will buy. So perhaps we should think about the dollar's weakness rather than gold's strength.** Here's a post from a Reuters blogger:

> If you look at the price of gold in a currency other than U.S. dollars, for instance Australian dollars, it hasn't gone up at all over the last few years. Gold isn't booming at the moment. The U.S. dollar is crashing. You

> think [gold is] worth a lot of U.S. dollars now? Just wait until QE4 or QE5.

This may or may not be from a qualified observer, but it's indicative of current sentiment. It's interesting in this connection that *The Wall Street Journal* reported as follows on December 3:

> Data cited Thursday by China's state-run Xinhua news agency showed that China imported 209.7 metric tons of gold in the first 10 months of the year, a fivefold increase compared with the same period last year.
>
> That surpassed purchases made by ETFs and surprised analysts, who until now had no clear insight into the size of China's buying. . . .
>
> "Everybody in the gold market knew there was a surge in investment demand, but they didn't know it was China," said Jeff Christian, managing director at CPM Group. . . .
>
> [This news] comes as the government loosens its restrictions on gold purchases by financial institutions and individual investors.

Money has to go someplace, and in these uncertain times, gold seems to be a destination of choice. Further, some of the objections to gold have eased:

- It used to be difficult and costly to transact in, especially in small amounts. But the creation of easily tradable ETFs has eased that concern.
- In the past, people would complain about the fact that gold doesn't throw off current income. But with interest rates ultra-low thanks to central banks, not much else does, either.

Removing impediments like these has the effect of increasing demand relative to supply. The short-run impact on price is clear.

The Usefulness of Gold as a Reserve Currency

In many ways, the rise in the popularity of gold may be largely the result of a process of elimination. Here's a helpful analysis from "Gold's Allure Grows Amid Instability," by James Saft writing in the *International Herald Tribune* (November 10):

> Real assets are the place to be when the solvency of the banking system is threatened and the authorities refuse to deal directly with it.
>
> With trillions in bank collateral that is worth less than its stated value on paper and with a U.S. economy mired in a balance sheet recession, the temptation to take care of these issues by creating more backed-by-nothing

money is too great. This is exactly what the Federal Reserve is doing in its latest $600 billion round of quantitative easing.

> This in turn is an invitation to the rest of the world to print money right back. There is no brake on this system other than the ability of nations to cooperate, and right now cooperation is not in everyone's individual interest. . . .
>
> You could argue that where we are now was a likely outcome of the current system. A global reserve currency in a fiat system creates tremendous incentives to take on too much debt.

In other words, **when (a) your income is inadequate to cover your spending, (b) you can borrow from abroad to cover the shortfall, (c) you can print the world's reserve currency with which to repay debt and (d) that currency isn't required to be backed by something tangible such as gold, printing money seems like the easy way out.** But as the world is learning about many things, that won't work without limitation.

The *Financial Times* reported as follows on November 13:

> Some policymakers think it is dangerous to rely on a single reserve currency, the dollar, from an economy that needs to borrow heavily from abroad. Amid Friday's failure of the Group of 20 industrial and emerging nations to reach any meaningful accord on global imbalances, France has promised as part of its G20 presidency next year to start a debate about the world's future monetary arrangements.

The world needs a reserve currency (or more than one). What candidates are there? The U.S. dollar, euro, sterling, yen, renminbi and gold.

The dollar has problems these days, and the world's opinion of it as a reserve currency is on the decline. If it hasn't fallen much in recent years relative to the euro and sterling – and in fact it's up strongly since late 2007 – that's mainly because the other two have bigger problems. Only the yen has strengthened relative to the dollar, due to belief in Japan's conservatism and solidity (although its massive national debt suggests otherwise).

Here's how World Bank president Robert Zoellick put it a month ago in arguing for a limited role for gold in the world monetary system:

> Gold has become a reference point because holders of money see weak or uncertain growth prospects in all currencies other than the renminbi, and the renminbi is not free for exchange.

That leads by default to gold. It's unlikely to take over from the others, but it may see further increases in demand, especially if nations conclude that the gold component of their reserves is too small relative to currency holdings. On the other hand, the role for gold appears likely to be limited because the small amount of gold that trades – and the swings in sentiment (and thus supply and demand) – render it awfully volatile for a serious component of the world monetary system. Further, the finiteness of the gold supply would limit potential economic growth in a gold-backed monetary system.

Most things in the international arena seem to argue against the dollar, and that can be viewed as implicitly arguing for an increased role for gold relative to the dollar. **But remember that because it can't be assessed quantitatively, no one can say definitively that the current price for gold doesn't already recognize and reflect all of the dollar's problems (and all of gold's merits).**

<u>The Bottom Line</u>

It was about two years ago that I first noted the similarity between gold and religion. Before that, I had always been a non-believer in gold (not strongly anti, just indifferent). But I concluded at the time – just as any wary agnostic might about God – that whereas I didn't believe in gold, I couldn't be 100% certain that was the right position. (It's like someone who considers himself non-superstitious but still favors lucky numbers and daily rituals "just in case.") So I stopped arguing against gold with any vehemence.

More importantly, I also concluded that since gold has "worked" for hundreds of years, it probably will keep on doing so. It might not do so forever, but what's the probability this will be the year it stops? So I wouldn't bet against it, and I might recommend a position "just in case." Not because I view gold affirmatively as a moneymaker, but rather as a useful contributor to safety through diversification. Surely the uncertain world situation seems to call for all the protection against the unknown that we can amass.

Still, the other hand brings me back to price. Yes, gold is probably more likely to continue serving as a store of value than to quit. And yes, maybe one should have a position. But is this the right price at which to start . . . ?

December 17, 2010

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Memo to: Oaktree Clients

From: Howard Marks

Re: On Regulation

I've been asked why there weren't any memos during the twelve weeks between September 9 and December 1. Lack of ideas? Writer's block? Carpal tunnel syndrome? CIA posting? The answer is "none of the above." I was putting the finishing touches on a book, *The Most Important Thing: Uncommon Sense for the Thoughtful Investor*. It pulls together all of the strands of my philosophy into what might be thought of as a super-memo. It will be published in late April and I hope you'll let me know what you think.

*   *   *

In the 3½ years since the financial crisis surfaced in July 2007, there has been extensive discussion of the part deregulation played in creating it, as well as the need for increased regulation to prevent the next one. The release last month of the report of the Financial Crisis Inquiry Commission reawakened the debate. Thus I'm often asked nowadays how I feel about regulation and what I think the future holds in that regard.

<u>The Swing of the Regulatory Pendulum</u>

I've written before that attitudes toward regulation follow the same pendulum-like swing as most other aspects of market behavior. They oscillate not only in response to events in the economic environment, but also because neither total regulation nor total deregulation produces an entirely satisfactory answer. As in so many things, there's no perfect solution.

A great source on the subject is *Wall Street Under Oath*, a 1939 book on the causes of the Great Crash of 1929 written by Ferdinand Pecora, who was counsel to the Senate committee investigating the crash and later a New York State judge. I first read it about twenty years ago, and I brought it out of storage in 2007. It is a typical polemic, assigning blame and touting regulation pursuant to what I assume were the author's philosophical/political biases (see page 4).

Pecora describes a Wall Street that, up to and including the 1920s, was like the Wild West. Bankers and brokers were out to make money for themselves; their behavior was largely unregulated; and conflicts between their interests and those of their clients were widespread and disregarded. In particular, according to Pecora, disclosure standards were non-existent.

These facts combined with other causes to produce a market crash of epic proportions; widespread losses; a drying up of capital; deflation; and a massive depression with a resulting increase in unemployment to 25%. Unsurprisingly, fingers were pointed at the prior administration and political power shifted to believers in an activist role for government. The most lasting result was the enactment of laws that governed the financial system for decades and in many cases still do: the Securities Act, the Securities and Exchange Act, and the Glass-Steagall Act. Thus the 1930s saw a massive swing of the pendulum in favor of regulation.

The next several decades on Wall Street were – perhaps thanks to the impact of those laws – a relatively placid period. This led to a view that, with rare exceptions, market participants are well-behaved by nature. Further, steady growth with only moderate dips caused a perception of an inherently benign and productive economy that could achieve even more if only the regulatory shackles were loosened. After President Carter deregulated the transportation industry in the late 1970s, the door was open for much of the regulatory apparatus built in the early part of the century to be relaxed. Ronald Reagan, whose famously free-market views coincided with a period of peace and prosperity, led the deregulatory charge. We saw a similar turn in Britain under the leadership of Margaret Thatcher; the collapse of the USSR and a resounding victory for capitalism; and the ascendance of free market adherents Alan Greenspan and George W. Bush.

With the economy and financial system generating prosperity, people wanted more of the same. And with manufacturing in decline, we relied heavily on the financial sector for an increased contribution to GDP, job creation and standards of living. The prevailing view was that the less regulation we had, the more productive business and finance could be. And what was there to be feared from an unregulated economy, anyway? The result in the past decade, according to a great newspaper quote that sadly I can't locate, was "the kind of regulation you get from an administration that doesn't believe in regulation."

Thus, coming full circle from the 1930s, starting in 1999 we saw revocation of Glass-Steagall; elimination of the up-tick rule limiting short sales to instances when stock prices were rising; a pivotal decision to exempt derivatives from regulation; increased permitted leverage at investment banks; and starvation of regulatory agency budgets. These developments were followed by the global financial crisis of 2007-08. Coincidence or causality?

<u>Free Markets Are Dangerous – Regulation is Essential</u>

The free-market, capitalist system runs on self interest and the desire for profit. We need regulation to ensure those things are kept within reasonable limits. Thus the goals of financial regulation are roughly as follows:

- to limit risk, especially risk to the overall financial system,
- to restrict the concentration of economic power,
- to protect customers, especially "the little guy,"
- to prevent error, fraud, misrepresentation and theft, and
- to democratize finance and make it a tool of social policy.

If ethics, self-regulation, personal responsibility, respect for risk and a sense of limits could be counted on, we wouldn't need much in the way of regulation. But, sadly, they can't.

Since the profit motive can lead financial institutions to aggressive risk taking, error and even misdeeds, regulation is counted on to prevent these things. There's also concern that individuals' self-interest might drive them to actions that collectively might injure their companies and society.

Free markets do a great job of allocating economic resources – especially on average over the long run – but the interim fluctuations produced by miscalculation can be intolerable and have to be modulated. This makes regulation indispensable. **Bottom line: the financial system can't be entrusted to untrammeled free markets.**

Regulation is Imperfect and Harmful – Free Markets Do It Best

On the other hand, regulation is too imperfect to be relied on. (Thanks to "Soggy" Sweat for this dialectical approach – see "All that Glitters," December 17, 2010.) It's easy to write hard-and-fast rules, but rules sometimes impose undue costs or restrict activity in undesirable ways. And their specificity often makes them capable of being circumvented. Because financial institutions are intent on innovation, rules rarely keep pace and regulators usually find themselves playing catch-up. Rule-writing is reactive: rules are written in response to the last problem, not to foresee and prevent the next one, which invariably is different. In addition, regulators lack the financial motivation that drives those who can profit from getting around regulations and exploiting loopholes.

Since rules become outdated and circumvented, it might be preferable to regulate through principles. In other words, rather than numerical limits and defined borders, regulations might be written in general terms to produce adherence to ideals and policy goals. But regulating this way requires that judgments be made, and regulators are rarely accorded the license required for judgment-making. Imagine the second-guessing, legal appeals and phone calls to congressmen that would follow an individual regulator's decision that a financial institution's actions have violated vague principles . . . especially during a halcyon period when the warned-of consequences are slow in coming.

Principle-based regulation requires not only flexibility that is hard to build into and nurture in bureaucracies, but also significant business acumen, perspicacity and foresight. The evidence is *prima facie*: very few people saw the risk posed by sub-prime mortgages and structured mortgage products, and certainly not the regulators. And no one I know of – regulator or otherwise – foresaw the effect these things would have on banks, money market funds and the commercial paper market.

Why didn't regulators say a word about rating agencies' dispensing many thousands of triple-A ratings to structured mortgage vehicles? Why were the highly regulated banks ground zero for the consequences of the financial crisis, while unregulated hedge funds were relatively unscathed? I just can't imagine that regulators will ever have the ability to fully anticipate the consequences of changes in the fast-developing financial system, or to foresee the development of new problems for which rules and responses have yet to be drawn up. Here's how Peter Sands, chief executive of Standard Chartered, was quoted in the *Financial Times* of January 27: "It is not clear why some regulators who were there before the crisis should believe they now have all the right solutions."

What regulator would have been able to make a difference in protecting our financial institutions (and the overall economy) from the developments of 2004-07? And given how valuable his skills would be in the private sector, how long would he have remained a regulator? No, it just doesn't make sense to expect government employees to safeguard the financial system. **The conclusion is inescapable: responsibility for the safety of the financial system can't be delegated to regulators.**

<u>The Origin of Attitudes</u>

In December I wrote of gold that it's like religion: either you believe in it or you don't. I think something very similar can be said about regulation of business and the economy.

Liberals who champion an expanded role for government tend to be pro-regulation, while conservatives favoring laissez-faire policies and limitations on government will argue against it with vehemence. Democrats generally like an activist government: that's what makes them Democrats. Republicans don't.

Those partaking in the benefits of economic growth tend to favor free-markets and oppose further regulation, since they're happy with things the way they are. The reverse is true for those who are failing to participate and those working in the public sector . . . although there are millions of exceptions on both sides. Businesspeople who trust the economy to perform for them generally oppose regulation, while members of labor want it to prevent their being taken advantage of by management and the owners of capital.

I think our attitudes in this regard are highly correlated with those of our parents and largely a function of the time and place we grew up in. They can be altered through exposure to opposing points of view, but I think most people's attitudes toward regulation stem far more from upbringing and circumstances than from analytical and intellectual processes. Attitudes toward regulation, like politics, are largely hereditary and change slowly if at all.

<u>Reconciling the Two Positions</u>

It's my belief that because both free markets and regulation are imperfect – and because of the strength of people's political and philosophical biases – we will never settle permanently on either a completely free market or a thoroughly regulated system. Any position will prove merely temporary, and the pendulum will continue to swing toward one end of the spectrum and then back toward the other.

- Scandals and crashes will cause a cry for regulation.
- Regulation will curb the excesses and punish the wrongdoers, discouraging repetition.

- The environment will calm, and economic progress will become the rule.
- Memory of the events behind the demand for regulation will fade.
- Free-marketeers will gain sway, and they'll argue that we could do even better if the system were deregulated.
- Regulation will be eased.
- Risk-taking and misdeeds will rise.
- Scandals and crashes will occur anew.
- Pro-regulation forces will regain influence, and free-marketeers will be in the doghouse.
- And the pendulum will swing back toward regulation.

There will never be total, lasting agreement on either complete regulation or totally free markets. **Importantly, however, it might well be the case that compromise between the two has the most dangerous consequences.**

- In the decade leading up to the crisis, politics favored home ownership and liberal mortgage availability. These forces, combined with unregulated mortgage securities markets, gave rise to excessive lending, exaggerated demand for mortgage securities (given the illusion of safety), and thus artificially low mortgage rates and loose terms.

- Which bailout recipients remain the biggest sinkholes, without any real chance of repaying the government's investment? The answer is Fannie Mae and Freddie Mac, the government-created mortgage agencies: supposedly private enterprises whose operations were distorted by a tacit federal guarantee. They engaged in uneconomic behavior, advancing the policy goal of making home ownership available to people who couldn't afford it, and accepting vast risk on the basis of inadequate capital because they (and their lenders) had no fear of loss.

- Legislators turned regulation over to the private sector by putting credit rating agencies in charge of financial institutions' investing standards, giving commercial organizations excessive imprimatur. Financial temptation pressured them to drop their standards, and when they succumbed, the previously sacrosanct triple-A rating became a meaningless label.

- Having witnessed the rescue of the banks and the financial system, we now have a system where free-market rewards will continue to motivate risk taking and no one believes the ultimate price – meltdown – will be demanded of too-big-to-fail institutions that take it too far. A free-market mechanism undercut by moral hazard may perform adequately 95% of the time, but it will pose terrible risks in the remainder.

The real bottom line is that since both free markets and regulation are imperfect, our financial systems will continue to be imperfect. They will work well for us most of the time, although not perfectly, and they will be subject to bubbles and crises every few decades (hopefully not more often).

The Recent Experience

Think about the last few years: the depth of the financial crisis, the pain it caused, the blunders (or worse) that were behind the crisis, the financial sector bailouts it necessitated, and the acrimony they elicited from a Main Street feeling left to fend for itself. Then add in a White House and Congress controlled by Democrats, with their leaning toward government involvement in the economy. Certainly this was a formula for a powerful upswing in regulation.

In this context, I'm surprised that we haven't seen much more government activism. The new financial regulations are mild and constrained, in my opinion. Increases in financial institution capital requirements and controls over executive compensation have generally been more moderate in the U.S. than in Europe. No one has gone to jail (or even been subjected to heavy fines) as in the Enron/Adelphia era. And there have been no punitive increases in taxes on "the rich."

And yet there have been enough steps toward regulation for their limitations to be manifest. One of the primary components of last year's new financial reform law was the so-called Volcker Rule, under which banks can no longer risk their capital on trading and investing for their own account. The bankers I meet with rail against the extent to which this will interfere with their ability to serve their customers and lay off risk. They further complain that actions inherent in market-making can be hard to distinguish from Volcker Rule violations. Where do positions held for trading and hedging stop and prop trading start? Think about Goldman Sachs's bets against subprime mortgages:

- Did they hedge Goldman's long positions in mortgages?
- Did they lessen the risk in Goldman's overall portfolio?
- Were they bets against Goldman's clients?
- Or did they enable Goldman to take positions that served its clients and otherwise engage in client facilitation?

I'd guess the answer is "all of the above." Clearly, however, a market maker can do far more to provide liquidity if it is allowed to hedge through offsetting positions.

Mortgage shorts also shored up Goldman's finances and made it one of the least needy financial institutions. Which would we like to have more of, Goldman Sachs or Lehman Brothers, which plunged into mortgages and derivatives without significant risk control and consequently went bankrupt? And yet Goldman's actions have been vilified and proprietary investing has been outlawed.

On February 6, a front-page *New York Times* story indicated how difficult it is to rein in free-market forces and self-interest. Although Washington pushed financial institutions to compensate executives through stock grants in order to align interests with shareholders (and mandated it at the very top), the article described non-mandated employees' success in hedging their shareholdings and thus sidestepping exposure to the risks affecting their companies.

> "Wall Street is saying it is reforming itself by granting stock to executives and exposing them to the long-term risk of that investment," said Lynn E. Turner, a former chief accountant at the Securities and Exchange Commission. "Hedging the risk can substantially undo that reform. . . ."
>
> More broadly, critics say, the practice of hedging represents another end run around financial reform.
>
> For example, new rules that cracked down on debit card fees have led several big banks to eliminate free checking. Firms also plan to make up missing revenue by adapting their businesses to the tougher new regulations on derivatives and trading with the banks' own capital.

The *Wall Street Journal* of February 18 provided another example:

> In November, Barclays PLC quietly changed the legal classification of the U.K. bank's main subsidiary in the U.S. so that the unit would no longer be subject to federal bank capital requirements. . . .
>
> The maneuver allows them to escape a provision of the financial-overhaul law that forces the pumping of billions of dollars of new capital into the U.S. entities, known as bank-holding companies.
>
> "It's just not worth it to have all that capital trapped" in the holding company, said a New York lawyer who is advising banks on how to restructure.
>
> The moves are the latest example of how banks are scrambling to cushion the impact of new laws and rules around the world.

The article went on to illustrate how a patchwork system can be evaded through regulator-shopping. By deregistering its subsidiary as a bank-holding company, Barclays escaped regulation by the Federal Reserve Bank, which would insist on greater capital. Instead its units now fall under the FDIC and the SEC, which will impose no such requirement.

The bottom line as far as I'm concerned is that you can enact a law or rule and tell businesspeople precisely what to do, but you can't make the economy or companies comply with policies and social aims. Regulations are limited in their scope and effect, and like a balloon, when you push in one place, self-interested behavior pops out in another. As these articles indicate, **those who enact regulation sometimes get it right at first glance, but they're rarely able to anticipate and control the response of those being regulated or the second-order consequences of the rules.**

Errors and misdeeds will occur as long as imperfect, self-interested humans stray into excessive risk-taking. And as long as these things lead to bubbles and resulting crashes, the willingness to dispense with regulation and rely on free markets will never be complete, regardless of regulation's limitations.

* * *

I believe a free market is the best decision maker, causing financial resources, labor and intellectual capital to flow where they are most valuable and thus have the potential to be best rewarded. But the ride will be bumpy – by necessity – and some of society's goals will go unfulfilled. Of course, those who favor limits on government involvement in business argue that financial and market regulation shouldn't be a vehicle for implementing social policy.

The collapse of the USSR shows the limits of a thoroughly controlled economy. On the other hand, it's likely that China's impressive accomplishments over the last decade have been aided by the fact that its economy is controlled, such that the movement of resources can be centrally mandated in the short run. China's purposefulness is impressive, and China likely would have accomplished less if it had to work entirely through free-market forces. Would we trade our system (and results) for theirs? Will our answer be the same in twenty years? And will China remain the same, or once the highly regulated system has raised standards of living, will people insist on freer markets as well?

The debate will inevitably go on:

- What system is most likely to produce the results we seek? In the last few years we've seen calls for regulations to require "prudent" mortgage lending and prevent "excessive" compensation. What system is best able to define these amorphous terms and produce these results?
- How will economic goals be integrated and balanced with society's other priorities, and should they be?
- How will laissez-faire economics and financial regulation coexist, and what will be the consequences?

These questions will never be answered conclusively. The swing of the pendulum will continue unabated.

March 2, 2011

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Memo to: Oaktree Clients

From: Howard Marks

Re: How Quickly They Forget

In January 2004 I received a letter from Warren Buffett (how's that for name dropping?) in which he wrote, "I've commented about junk bonds that last year's weeds have become this year's flowers. I liked them better when they were weeds."

Warren's phrasings are always the clearest, catchiest and most on-target, and I thought this Buffettism captured the thought particularly well. Thus for Oaktree's 2004 investor conference we used the phrase "Yesterday's Weeds . . . Today's Flowers" as the title of a slide depicting the snapback of high yield bonds. It showed the 45% average yield at which a sample of ten bonds could have been bought during the Enron-plus-telecom meltdown of 2002 and the 6% average yield at which they could have been sold in 2003; **on average, the yields had fallen by 87% in just thirteen months**. The idea went full-circle in 2005, when Warren used our slide at the Berkshire Hathaway annual meeting to illustrate how rapidly things can change in the world of investing.

And that's the point of this memo. Asset prices fluctuate much more than fundamentals. This happens because, rather than applying moderation and balancing greed against fear, euphoria against depression, and risk tolerance against risk aversion, investors tend to oscillate wildly between the extremes. They apply optimism when things are going well in the world (elevating prices beyond reason) and pessimism when things are going poorly (depressing prices unreasonably). Shortness of memory plays a major part in abetting these swings. If investors remembered past bubbles and busts and their causes, and learned from them, the swings would moderate. But, in short, they don't. And they may be forgetting again.

High yield bonds and many other investment media have once again gone from being weeds to flowers – from pariahs to market darlings – and it happened in a startlingly short period of time. As is so often the case, things that investors wouldn't touch in the depths of the crisis in late 2008 now strike them as good buys at twice the price. The swing of this pendulum recurs regularly and creates some of the greatest opportunities to lose or gain. Thus we must always be mindful.

<u>The Importance – and Shortcomings – of Investment Memory</u>

A number of my favorite quotations are on the subject of history and memory, and I've used them all in past memos. Humorist and author Mark Twain talked about the relevance of the past:

> History doesn't repeat itself, but it does rhyme.

The philosopher Santayana stressed the penalty for failing to attach sufficient importance to history:

> Those who cannot remember the past are condemned to repeat it.

And economist John Kenneth Galbraith described the shabby way investors treat history and those who consider it important:

> 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, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. 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 the insight to appreciate the incredible wonders of the present.

String together these three pearls of wisdom and you get a pretty accurate picture of investment reality. **Past patterns tend to recur. If you ignore that fact, you're likely to fall prey to those patterns rather than benefit from them. But when markets get cooking, the lessons of the past are readily dismissed.** These are nothing short of eternal verities, and their collective message is indispensible.

Why Does Investment Memory Fail?

Think back to the emotions you felt so strongly during the recent financial crisis, and the terrifying events that brought them on. You swore at the time that you'd never forget, and yet their memory has receded and nowadays has relatively little influence on your decisions. Why does the collective memory of investment experiences – and especially the unpleasant ones – fade so thoroughly? There are a number of reasons.

- **First, there's investor demographics.** When the stock market declined for three straight years in 2000-02, for example, it had been almost seventy years since that had last happened in the Great Depression. Clearly, very few investors who were old enough to experience the first such episode were around for the second.

  For another example, I believe a prime contributor to the powerful equity bull market of the 1990s and its culmination in the tech bubble of 1999 was the fact that in the quarter century from 1975 through 1999, the S&P 500 saw only three minor annual declines: 6.4% in 1977, 4.2% in 1981, and 2.8% in 1990. In order to have experienced a bear market, an investor had to have been in the industry by 1974, when the index lost 24.3%, but the vast majority of 1999's investment professionals doubtless had less than the requisite 26 years of experience and thus had never seen stocks suffer a decline of real consequence.

- **Second, the human mind seems to be very good at suppressing unpleasant memories.** This is unfortunate, because unpleasant experiences are the source of the most important lessons. When I was in army basic training, I was sure the memories would remain vivid and provide material for a great book. Two months later they had disappeared. After the fact, we may remember intellectually but not emotionally: that is, the facts but not their impact.

- **Finally, the important lessons of the past have to fight an uphill battle against human nature, and especially greed.** Memories of crises tell us to apply prudence, patience, moderation and conservatism. But these things seem decidedly outdated when the market's in a bull phase and risk bearing is paying off, and if practiced they appear to yield nothing but opportunity costs.

  Charlie Munger contributed a great quote to my recent book, from Demosthenes: "Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true." **In other words, there's a powerful tendency to believe that which could make one rich if it were true**.

I've tried to spend the last 42 years with my eyes open and my memory engaged. As a result, a lot of what I write is based on recognition of past patterns. It's time to put my recollections to work, because I'm definitely seeing a trend in the direction of Galbraith's "same or closely similar circumstances."

<u>The Not-So-Distant Past</u>

It seems it was impossible – unless you were John Paulson – to escape entirely unscathed from the financial crisis of 2007-08. Most investors could only hope to have turned cautious in the run-up to the crisis, sold assets, increased the defensiveness of their remaining holdings, reduced or eschewed leverage, and secured capital with which to buy at the bottom in order to benefit from the subsequent recovery.

What might have prompted investors to do these things in advance of the mid-2007 onset of the crisis? Almost no one fully foresaw the impending subprime meltdown, and few macro-forecasts and market analyses were sufficiently pessimistic. Rather, I think investors would have been most likely to take the appropriate actions if they were aware of the pro-risk behavior taking place around them.

One of the most important things we can do is take note of other investors' attitudes and behavior regarding risk. Fear, worry, skepticism and risk aversion are the things that keep the market at equilibrium and prospective returns fair. When investors fear loss appropriately, too-risky deals can't get done, and risky investments are required to offer high prospective returns and generous risk premiums. (And when fear reaches extreme levels during crises, the capital markets turn too stingy, asset prices sink too low, and potential returns become excessive.)

But when investors don't fear sufficiently – when they're risk tolerant rather than risk averse – they let down their guard, surrender their discipline, accept rosy projections, enter into unwise deals, and settle for too little in the way of prospective returns and risk premiums.

The years immediately preceding the onset of the crisis in mid-2007 constituted nothing short of a "silly season." It seemed the financial world had gone crazy, with deals getting done that were beyond reason. Investors acted as if risk had been banished. They believed that the markets had been rendered safe by the combination of (a) an omniscient, omnipotent Fed providing a "Greenspan put," (b) the wonders of securitization, tranching and selling onward and (c) the "wall of liquidity" coming toward our markets, composed of excess reserves being recycled by China and the oil-producing nations. They accepted the alchemy under which financial engineering could turn sub-prime mortgages into triple-A debt. And they viewed leverage as sure to have a salutary effect on returns.

There's nothing more risky than a widespread belief that there's no risk . . . but that's what characterized the investment world. It was possible to conclude in 2005-07 that investors were applying insufficient risk aversion and thus engaging in risky behavior, elevating asset prices, reducing prospective returns, and raising risk levels. What were the signs?

- The issuance of non-investment grade debt was at record levels.
- An unusually high percentage of the issuance was rated triple-C, something that's not possible when attitudes toward risk are sober.
- "Dividend recaps" went unquestioned, with buyout companies borrowing money with which to pay dividends, vastly increasing their leverage and reducing their ability to get through tough times.
- Credit instruments were increasingly marked by few or no covenants to protect lenders from managements' machinations, and by interest payments that could be made with debt rather than cash at the companies' discretion.
- Collateralized loan and debt obligations were accepted as being respectable instruments – with the risk made to vanish – despite the questionable underlying assets.
- Buyouts of larger and larger companies were done at increasing valuation multiples, with rising debt ratios and shrinking equity contributions, and despite the fact that the target companies were increasingly cyclical.

- Despite all of these indications of falling credit standards and rising riskiness, the yield spread between high yield bonds and Treasury notes shrank to record lows.
- The generous capital market conditions and low cost of capital for borrowers caused buyout fund managers to describe the period as "the golden age of private equity." Conversely, then, for lenders it was the pits.

In 2005-07, investors suspended skepticism and disbelief, ignored the risk of loss, and obsessed instead about avoiding the risk of missing opportunities. This caused them to buy securities at low implied returns; employ vast amounts of low-cost debt to lever up those returns; loosen the terms on debt they would provide; and participate in black-box vehicles on the basis of investment banks' recommendations, the nontransparent machinations of financial engineers, and the imprimatur of far-from-perfect rating agencies.

In short, investors were oblivious to risk and thus failed to demand adequate risk premiums. The environment could only be described as euphoric. Here's how I put it in "It Is What It Is" (March 2006):

> The skinniness of today's risk premiums can be observed most clearly in the high yield bond market, where prospective returns can be calculated with precision and yield spreads are in the vicinity of historic lows, and in certain real estate markets, where actual cash returns are similarly low. But the difficulty of quantifying prospective returns in public and private equity doesn't mean the offerings there are any less paltry. And, as Alan Greenspan said, **". . . history has not dealt kindly with the aftermath of protracted periods of low risk premiums."**

<u>Market Conditions Today</u>

In May 2005, I wrote a memo entitled "There They Go Again," complaining that investors were taking excessive comfort from mindless platitude of the type that accompany and abet the creation of every bubble. These are accepted as a substitute for putting rational intrinsic valuations on the assets that are the subject of the bubble, and despite repeated evidence that trees can't grow to the sky. I touched on the mania for real estate, as well as the growing popularity of hedge funds and private equity. I went on to assert that this behavior – and the supportive underlying capital market trends – had turned the markets into a "low-return world."

I recite all of this because I have no doubt that investors are making substantial movement back in the same direction. To illustrate, here's an account of capital market conditions in 2011 (*Bridgewater Daily Observations*, February 15):

> Consistent with the pickup in credit creation that we have seen elsewhere, LBO activity and the credit pipes that are supporting it have recently improved. Since the first quarter of 2010 we have seen a steady rise in LBO activity, starting from a very

> low base. The rate of activity is now roughly similar to the average level of activity since 1985, excluding the boom and bust period of 2006 to 2009. . . . today's deals are similar in size but the number of deals has risen by more than the dollar value of deals. We also see that the leverage in the deals is increasing. For example, so far this year the average deal was financed with 30% equity, down from last year's 38%, though still up from the most leveraged period of 2005 to 2009 when deals were financed with an average of 25% equity. The leveraged loan market has also picked up and an increasing percentage of leveraged loans are going toward LBOs. A few new CLOs and mutual funds have been created that are concentrated on the leveraged loan market, indicative of renewed demand. Investor demand has pushed prices back up to par and allowed a decline in the average credit quality of the loans, with increasing indications of "covenant light" loans getting done.

In other words, in most regards the capital markets – and investors' tolerance of risk – are retracing their steps back in the direction of the bubble-ish pre-crisis years. Low yields, declining yield spreads, rising leverage ratios, payment-in-kind bonds, covenant-lite debt, increasing levels of LBO activity and the beginnings of the return of levered, structured vehicles . . . all of these are available for the eye to see.

For a case in point, let me recap a note I received from one of our veteran high yield bond analysts regarding a deal that recently had come to market:

- PIK/toggle bonds: the company can elect to pay interest in debt rather than cash
- Holdco obligation: debt of a holding company, removed from the moneymaking assets
- Use of proceeds: to pay a dividend to the equity sponsor, returning half of the equity it put into the company just a few months earlier
- The sponsor's purchase price for the company in 2010 was 1.45 times what the seller had bought it for in 2008
- The company operates in a commodity industry where annual sales are shrinking and costs are variable and unpredictable
- Negative earnings comparisons are expected, since the environment makes it hard to pass on rising raw material costs
- EBITDA coverage of interest expense plus capital expenditures is modestly above 1x
- The company is incorporated in Luxembourg, an uncertain bankruptcy environment
- The assessment of Oaktree's Sheldon Stone: "I know they don't ring a bell at the top, but they should on this deal!"

It's easy to gauge bond investors' attitudes. Here are the yield to maturity and yield spread versus Treasurys on the average high yield bond at a few points in the recent past and today:

	Yield to Maturity	Spread vs. Treasurys
"Normal" – December 31, 2003	8.2%	443 b.p.
Bubble peak – June 30, 2007	7.6	242
Panic trough – December 31, 2008	19.6	1,773
Recovered – March 31, 2010	9.0	666
Shrinking again – April 30, 2011	7.5	492

The yield spread on the average high yield bond is still on the generous side relative to the 30-year norm of 350-550 basis points, a range of spreads that has given rise to excellent relative returns over that period. On the other hand, (a) spreads have fallen back to the normal range from the crisis-induced stratosphere and (b) the lowness of today's interest rates means that reasonable spreads translate into promised returns that are low in the absolute. The story's the same for many asset classes.

I don't mean to pick on high yield bonds. I use them here as my prime example only because of my familiarity with them and because their fixed-income status facilitates quantification of attitudes toward risk. In fact, high yield bonds still deliver above average risk compensation, and they remain the highest returning contractual instruments and excellent diversifiers versus high grade bonds.

If you refer back to a memo called "Risk and Return Today" (November 2004), you'll see that today's expected returns and risk premiums – especially on the left-hand side of the risk/return spectrum – are eerily similar to those prevailing in late 2004: money market at 1%; 5-year Treasurys at 3%; high grade bonds at 5%; high yield bonds at 7%; stocks expected to return 6-7%. I said at the time that low base interest rates and moderate demanded risk premiums had combined to render the risk/return curve "low and flat." In other words, absolute prospective returns were at modest levels, as were the return increments that could be expected for taking on incremental risk. I described that environment as "a low-return world." I think we're largely back there.

(Please note that late 2004 was nowhere near the cyclical peak. Security prices continued to rise and prospective returns to fall for two and a half years thereafter. In particular, in the 30 months following the publication of that memo, high yield bonds went on to return a total of 19.7%. So similarities to 2004 don't constitute a sign of impending doom, but perhaps a foreshadowing of a potential move into bubble territory.)

I want to state very clearly that I do not believe security prices have returned to the 2006-07 peaks. It doesn't feel like the silly season is back in full. Investors aren't euphoric. Rather they seem like what my late father-in-law used to call "handcuff volunteers" – people who do things because they have no choice. They're also not oblivious to the risks that exist. I imagine the typical investor as saying, "I'm not happy, but I have to buy it." Finally, the leverage used at the peak of risk-prone pursuit of return in 2005-07 isn't nearly as prevalent today, perhaps because investors are chastened, but more likely because it's not available in the same amounts.

There may be corners of the market where elevated popularity and enthusiastic buying have caused prices to move beyond reason: high-tech stocks, social networks, emerging markets from time to time, perhaps gold and other commodities (what's the reasonable price for a non-cash-flow-producing asset?) But for the most part, I think investors are taking the least risk they can while assembling portfolios that they think can achieve their needed returns or actuarial assumptions.

In general, I would describe most security prices as falling somewhere between fair and full. Not necessarily bubbly, but also not cheap.

Especially since the publication of my book, people have been asking me for the secret to risk control. "Okay, I'll read the 180 pages. But what's really the most important thing?" **If I had to identify a single key to consistently successful investing, I'd say it's "cheapness."** Buying at low prices relative to intrinsic value (rigorously and conservatively derived) holds the key to earning dependably high returns, limiting risk and minimizing losses. It's not the only thing that matters – obviously – but it's something for which there is no substitute. Without doing the above, "investing" moves closer to "speculating," a much less dependable activity. When investors are serene or even euphoric, rather than discomforted, prices rise and we become less likely to find the bargains we want.

So if you could ask just one question regarding an individual security, asset class or market, it should be "is it cheap?" Oaktree's investment professionals try to ask it, in different ways, every day.

And what makes for cheapness? In sum, the attitudes and behavior of others.

I try to get away from it, but I can't. The quote I return to most often in these memos, even 17 years after the first time, is another from Warren Buffett: "The less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs." When others are paralyzed by fear, we can be aggressive. But when others are unafraid, we should tread with the utmost caution. **Other people's fearlessness invariably translates into inflated prices, depressed potential returns and elevated risk.**

Today, pension funds and endowments simply can't achieve their goal of nominal returns in the vicinity of eight percent if they keep much money in Treasurys or high grade bonds, and they may not even expect public equities to be much help. They've moved into high yield bonds, private equity and hedge funds . . . not because they want to, but because they feel they have to. They just can't settle for the returns available on more traditional investments. Thus their risk taking is in large part involuntary and perhaps unenthusiastic.

So where do we stand today?

- General interest rates are some of the lowest in history.
- Yield spreads are about normal.
- Returns on low-risk assets are reasonable in relative terms but skimpy in the absolute.
- Investors are forced toward pro-risk behavior because of the lowness of returns in the safer, low-risk portion of the risk/return curve.
- Thus investors are jettisoning the conservatism they adopted at the depths of the financial crisis, in many cases not out of choice.
- Investors are once again engaging in risky behavior, albeit not at peak levels of riskiness.

Those of us who calibrate our behavior based on what others are doing should increase watchfulness and, as Buffett suggests, apply rising amounts of prudence.

<u>How Did Things Get This Way?</u>

Just two and a half years ago, in the depths of the financial crisis, I was convinced that pro-risk psychology had undergone lasting damage. With investment banks, rating agencies and financial engineers defrocked, no-lose investments collapsing, account balances decimated and investors disillusioned, it seemed it might be years before market psychology recovered. And yet markets began a dramatic recovery in early 2009, investors have returned to bearing risk, and many indices are back in the vicinity of their pre-crisis peaks. What's behind this turn of events?

In 2007 and 2008, governments around the world rushed to support financial institutions and stimulate economies. They did this by making liquidity readily available and cutting interest rates to near zero.

Everyone knew the rate cuts would stimulate the economy by encouraging borrowing and reducing the cost of doing business, and that they would increase the profit margin in lending, buttressing financial institutions. But I don't think anyone fully appreciated the impact they would have on reviving pro-risk behavior.

In short, the rate cuts made it unrewarding to hold cash, T-bills and high grade bonds. Investors looking for returns in line with their needs – or income on which to live – were literally forced to move into riskier asset classes in pursuit of returns in excess of a few percent.

Much of the money that normally would be invested in the giant Treasury market simply couldn't stay there because the yields were so low. Thus large amounts flowed toward smaller markets where they were quite capable of lifting prices. Nothing can reduce returns, worsen terms or raise risk faster than "too much money chasing too few deals." **It's disproportionate flows of capital into a market that give rise to the disastrous race to the bottom such as we saw in 2005-07. Greater sums are provided to weaker borrowers at lower interest rates and with looser terms. Higher prices are paid for assets: first less of a discount from intrinsic value, then the full intrinsic value, and eventually premiums above intrinsic value.** These processes account for many of the trends decried here.

In addition, I would point out that the pain of the crisis was surprisingly short-lived. The real panic began on September 15, 2008, the day Lehman Brothers filed for bankruptcy. Until then, the world seemed to be coping and investors retained their equanimity. But Lehman, Fannie Mae, Freddie Mac, Merrill Lynch, Washington Mutual and AIG fell like dominoes in short order, and in the last fifteen weeks of 2008 people were paralyzed by fear of a global financial meltdown.

And then things turned in the first quarter of 2009, primarily, I think, because people were coerced to move further out on the risk curve as described above. Since then the markets have risen dramatically from their lows.

In distressed debt, for example, the post-Lehman days and weeks were characterized by terror, uncertainty, forced selling, illiquidity and huge mark-to-market losses. But if you look back, you see that the panic and pain – and thus the greatest buying opportunity – really lasted only fifteen weeks, through the end of 2008. Prices continued downward in the first quarter of 2009, but without the deluge of supply brought on by the previous quarter's forced selling. By April prices were headed up. So the lesson was painful but short-lived and, apparently, easily forgotten.

As usual, the cyclical upswing is circular and self-reinforcing. It takes on the appearance of a virtuous cycle that will proceed non-stop, and it does so . . . until it fails. Here's an example of the process at work:

- The pursuit of return caused people to move from Treasurys to high yield bonds.
- The revival of demand enabled companies to raise money.
- The reopening of the capital markets made it possible for companies to do bond exchanges and refinancings: extending maturities, extinguishing covenants and capturing bond discounts, converting them into reduced amounts of debt outstanding. In some cases equity could be issued to delever balance sheets.
- These remedial actions improved companies' creditworthiness and brought down the default rate on high yield bonds from 10.8% in 2009 to a startling 1.1% in 2010, the greatest one-year decline in history.

- The resulting price appreciation produced profits for those who'd bought, turning investor psychology more rosy and producing envy – and thus a rush to join in – among those who had been slow to invest.
- And the combination of these things convinced people that conditions had improved, making them still more willing to take on increased risk.

I thought the lessons of 2007-08 had been etched into people's psyches, and that the return to pro-risk behavior would therefore be slow. But clearly that hasn't been the case.

<u>Prudent Behavior in a Low-Return World</u>

The 2005 memo I mentioned earlier, "There They Go Again," proceeded from the discussion of the low and flat risk/return curve contained in "Risk and Return Today" to ponder what investors might do in times of low prospective returns and risk premiums. The possibilities fell into just a few categories:

- Go to cash – not a real alternative for most investors.
- Ignore the lowness of absolute returns and pursue the best relative returns.
- Forget that elevated prices might imply a correction, and buy for the long run.
- Reach for return, going out further on the risk curve in pursuit of returns that used to be available with greater safety.
- Concentrate investments in "special niches and special people"; by this I meant emphasizing strategies offering exceptional bargains and managers with enough skill to wring value-added returns from assets of moderate riskiness.

Of all of these, I consider reaching for return to be the most flawed, especially if it's done without being fully conscious (which is often the case when return becomes hard to come by). I've described this approach as "insisting on achieving high returns in a low-return world" and reminded people of Peter Bernstein's admonition: "The market's not a very accommodating machine; it won't provide high returns just because you need them."

Here's what I wrote in May 2005:

> Given today's paucity of prospective return at the low-risk end of the spectrum and the solutions being ballyhooed at the high-risk end, many investors are moving capital to riskier (or at least less traditional) investments. But (a) they're making those riskier investments just when the prospective returns on those investments are the lowest they've ever been; (b) they're accepting return increments for stepping up in risk that are as slim as they've ever been; and (c) they're signing up today for things they turned down (or did less of) in the past, when the prospective returns were much higher. This may be exactly the wrong time to add to risk in pursuit of more return. You want to take risk when others are fleeing from it, not when they're competing with you to do so.

Even six years later, I can't think of any responses to a low-return world beyond those enumerated above. Limit risk, sacrificing return. Accept risk in pursuit of return, and pray the consequences will be tolerable. Or strive to find ways to augment returns through means other than risk bearing.

None of these possible solutions is perfect and without pitfalls. In fact, each brings its own form of risk. Staying safe entails the risk of inadequate return. Reaching for return increases the risk of financial loss. And the search for "alpha" managers introduces the risk of choosing the wrong ones. But, as they say, "it is what it is." When it's a low-return world, there are no easy solutions devoid of downside.

<u>The Right Approach for Today</u>

One of the things that makes investing interesting is the ever-changing nature of the route to profit, the pitfalls that are present, and the tools and approaches that should be employed. Conscious decisions regarding these things should underlie all efforts to manage capital, and they must be revisited constantly as circumstances and asset prices change. What's right today?

First, should you prepare for prosperity or not? By prosperity I mean a return to the happy days of the 1980s and '90s, when reported economic growth was strong and consumers were eager to spend. My answer is that we're not likely to see anything like that, in large part because in those decades the gap between stagnant incomes and vigorous consumption growth was bridged through buying on credit. Instead, in the years ahead I think (a) growth in employment and incomes will be sluggish, (b) consumers should be restrained in their borrowing as a result of having experienced the crisis, (c) consumer credit shouldn't be available as readily, and (d) borrowing against home equity will be much less of a factor, especially because home equity is so scarce.

Second, should you worry more about losing money or about missing opportunities? This one's easy for me. First, the macro uncertainties tell me we won't be seeing a highly effervescent economy or market environment. Second, other people's increasingly aggressive behavior tells me to seek cover. And third, since I don't see many compellingly cheap assets, I doubt there will be gains big enough to make us kick ourselves for having invested too cautiously.

And that brings me to my third question: what tools should you employ? In late 2008 and early 2009, you needed just two things to achieve big profits: money to commit and the nerve to commit it. If you had caution, conservatism, risk control, discipline and selectivity, you probably achieved lower returns than otherwise (although having factored those things into your analysis might have given you the confidence needed to implement favorable conclusions in that terrible environment). The short answer was simple: money and nerve.

But what if you had money and nerve in 2006 or early 2007? The results would have been disastrous. In those times you needed caution, conservatism, risk control, discipline and selectivity to stay out of trouble. **In short, when the market is defaulting on its job of being a disciplinarian, discernment becomes our individual responsibility.**

So then, which is the right set of equipment for today? I think we're back to needing the cautious attributes, not the aggressive. An unusually large number of thorny macro issues are outstanding, including:

- the so-so U.S. recovery;
- the U.S.'s deficit, debt ceiling impasse and dysfunctional political process;
- the economic impact of deleveraging and austerity;
- the over-indebtedness of peripheral eurozone countries;
- the possibility of rekindled inflation and rising interest rates;
- the uncertain outlook for the dollar, euro and sterling; and
- the instability in the Middle East and resulting uncertainty over the price of oil.

With all of these, plus prices that are fair to full and investor behavior that has increased in aggressiveness, I would rather gird for the things that can go wrong than ensure maximum participation if things go right. (Of course that's not an unfamiliar refrain from me.)

The other day, the investment committee of a non-profit on which I sit decided to take the first steps toward marshaling resources and managers so as to be ready to buy into beaten-down assets after the next round of bubble and bust. And it wasn't even my idea!

We can never be sure what will happen – and certainly not when – but it's important to be prepared for what's likely to lie ahead. And understanding the inevitable pendulum swing in the way investments are viewed – from weeds to flowers and back – is an essential ingredient in being able to do so.

May 25, 2011

P.s.: I hope you'll consider rereading "Risk and Return Today" (November 2004) and "There They Go Again" (May 2005) (see http://www.oaktreecapital.com). Hopefully they'll strengthen the case for reflecting on past patterns and help you think through the current conditions. You might also take a look at "The Cat, the Tree, the Carrot and the Stick" in "What's Going On" (May 2003) for a metaphorical look at the process of risk acceptance. Today's echoes of those past times are worth noting.

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Memo to: Oaktree Clients

From: Howard Marks

Re: Down to the Wire

Here are the ingredients in the plot: A problem everyone's aware of. If it isn't resolved, a shutdown with unspecified but possibly disastrous consequences. A deadline which seems indispensable, since in its absence it appears nothing would be done. And despite the presence of the oncoming freight train, movement toward a solution is deterred by highly entrenched positions. It's truly white-knuckle time, and if the progress toward a solution continues to lag, the things that must happen won't.

I'm not talking about the nearly concluded drama at the National Football League, where failure to reach a labor settlement for just a few more days would have caused significant changes in the schedule for the coming year, upsetting the flow of wealth to owners and players and depriving fans of the game they love. I'm talking about the down-to-the-wire battle over the U.S. debt ceiling. I've decided to devote a memo to the debt issue and its significance. I especially hope it'll be helpful to our non-U.S. clients, for whom the lack of progress to date must be absolutely incomprehensible.

Interestingly, the immediate debt crisis is somewhat artificial. It is occasioned now only because of our debt ceiling, which currently limits the net debt of the United States to $14.29 trillion. Such ceilings are far from the norm worldwide. Many other nations seem to function no worse without them.

But the U.S. has the historical accident of a ceiling, and we must deal with it. Because the limitation is set in terms of absolute dollars and not indexed for inflation or growth, we would run into it every few years even if our debt only grew apace with the economy. "In fact, it's been raised nearly 100 times over the decades." (*Financial Times*, July 16) But thanks to the especially rapid growth of our debt relative to GDP in recent years – exacerbated by the Afghan and Iraq wars and the financial crisis – the ceiling has the potential to provide some real excitement every once in a while.

The Relentless Growth of Debt

Greece, Ireland, Portugal, Spain, Italy, Iceland, the U.S., California . . . the list of governments with debt problems is long and grows longer. The issue has flared up in the last fifteen months and is often in the headlines nowadays.

And yet, the general conditions causing the concern are nothing new. The deficits and debt that worry people today have existed for a good while: similar in kind albeit perhaps not in degree. This merely shows that in the economic/investment world, what matters most in the short run isn't necessarily what's true but, rather, what's on people's minds.

Serious attention began to be paid to government debt in April 2010, when the Greek crisis burst into the news. Prior to that, no one seemed to worry about the way Greece – like many other countries – increased its budget deficit and national debt each year relative to its GDP. Banks and investors around the world were perfectly willing to extend credit without limitation based on Greece's strong EU-backed credit rating, and without thought as to whether there was any prospect for Greece ever paying down the debt, or even slowing its growth or growing out of it.

If you ask me, one of the most pronounced trends in the global economy over the course of my 42-year career has been the growth in the use of credit. And it's not just governments that have vastly expanded their use of credit over this period.

If I wanted to buy something upon my arrival at college in 1963, I had two choices: I could spend money I had in my pocket, or I could write a check against money I had in the bank. The one thing I couldn't do – now here's a radical concept – is spend money I didn't have. As a result, I had no way to buy things I couldn't afford.

But then, around 1967, Bank of America came out with the first credit card, the BankAmericard, and First National City Bank countered with The Everything Card. (When I was hired into FNCB that year for my first summer job, it was to go door-to-door trying to convince merchants to accept the card. But then volume on the New York Stock Exchange spiked to 25 million shares a day and banks like FNCB couldn't keep up with the related paperwork; thus I was assigned instead to a task force whose job it was to eliminate bottlenecks in the back office. But that's another story.)

Before the BankAmericard and The Everything Card, the only plastic in circulation consisted of T&E ("travel and entertainment") cards – American Express, Diners Club and Carte Blanche – which generally were limited to people in the upper economic strata and had to be paid off each month. It was only in the last forty years that we've seen the morphing of BankAmericard into Visa and The Everything Card into MasterCard. With them came the ability of consumers to maintain an outstanding balance. Now it was easy for people to buy things they couldn't afford. And so they did.

When I was a boy, as I recall, owing money was considered undesirable and debts were generally expected to be paid off. When people bought homes, they put down 30% and took out thirty-year mortgages to finance the rest. They made level payments that included a substantial principal component that grew over time, eventually extinguished their debt, invited their friends over for mortgage-burning parties, and owned their homes free and clear in time for retirement.

But attitudes toward debt underwent significant change, and in the last forty years we've seen the following:

- Vast expansion of the use of credit cards, the balances on which are never expected to be paid off.
- Innovative mortgages requiring little or no principal amortization; reverse mortgages, where you owe more at the end than the beginning; declining down payment requirements; and eventually the availability of mortgage loans exceeding purchase prices.
- Home equity loans enabling owners to drain off any equity in their homes. Fifty years ago these were called second mortgages, and people who had them were considered by their neighbors to be in financial trouble.
- Growth in corporate debt, and the extension of borrowing power to companies with "speculative" credit ratings.
- The development of the commercial paper market, where companies could access "permanent" capital with maturities measured in days, on the assumption that the paper could always be rolled over.
- Creation of highly levered investment entities.
- Vastly increased steady-state borrowing on the part of nations, whereas, previously, deficit spending had been limited to occasional efforts to fight recession through stimulus.

What's the upshot of all of this? For the last several years, as I've visited with clients around the world, I've described the typical American as follows (exaggerating for effect, of course): He has $1,000 in the bank, owes $10,000 on his credit card, makes $20,000 a year after tax, and spends $22,000. And what do lenders do about this? They mail him additional credit cards.

Most people laugh – perhaps uncomfortably – when they hear this. But no one says it's inaccurate or benign. The bottom line is that consumer credit has been extended without any thought for how the full balance might ever be paid off. As long as the borrower is able to make monthly payments covering the interest and a tiny bit of principal, the situation is considered acceptable. But that's not my version of fiscal health.

So now let's jump from the top of the above list of developments to the bottom. In much the same way, credit has been available to governments deemed creditworthy without limit and without concern for the fact that:

- Countries were constantly spending more than they were taking in.
- Their deficits were growing non-stop relative to GDP.
- Their national debts likewise were expanding relative to GDP.
- In other words, repayment of principal was absolutely unimaginable.

One of the most striking aspects of debt in the modern era is that little if any attention is paid to repayment of principal. No one pays off their debt. They merely roll it over . . . and add to it. Thus credit ratings are highly deficient (shocker!) in a way that few people talk about. What ratings describe isn't the borrower's ability to repay principal, but its ability to make interest payments and refinance principal. But the assessment of their ability to roll their debt – likewise – isn't based on an ability to repay, but rather to refinance again. So ultimately the security of capital providers stems not from the borrower, but from the continued willingness of other capital providers to roll debts in the future. (It was their occasional refusal in 2007-08 that caused the worst moments of the financial crisis.)

With no one asking how debt could be repaid, nations were allowed for decades to increase their deficits and debt non-stop relative to their GDP. And then, in the first quarter of 2010, the little boy stepped out from the crowd, took note of the emperor's non-existent new clothes, and said "Hey, wait a minute: Greece will never be able to repay even the debt it has, forgetting that it takes on more all the time. Its economy is non-competitive and stagnant, and tax compliance is non-existent. They shouldn't be able to borrow."

That's all it took. Greece was denied further credit. And then people took a look around peripheral Europe and saw more of the same. Today, although the situation is nowhere as dire, they're also looking at the U.S. and some of its states.

It's Not the Ceiling

In June, the debt of the U.S. reached the ceiling, meaning no more could be issued. That's bad news for a country that continuously spends more than it takes in. Thus the deadline imposed by the debt ceiling has brought the issue to the forefront. (If the debt limit was reached in June and we've continued to spend more than our revenues, how have we financed the shortfall? The federal government has borrowed from federal retirement funds; the courts ruled in the past that when we do this, it's not an expansion of our net debt, since America is borrowing "from itself." The well-known deadline of August 2 is the date on which the capacity for borrowing in this way is projected to be exhausted.)

The problem isn't the ceiling, it's our behavior. The debt ceiling merely imposes a discipline that our national leaders should provide but generally haven't. On this note, in his press conference on July 15, when asked about conservatives' insistence on a balanced-budget amendment to the Constitution, President Obama replied, "We don't need a constitutional amendment to do that [balance the budget]; what we need to do is to do our jobs." **But clearly we do need some enforced discipline, because the years in which we haven't run a deficit have been by far the exception of late, not the rule.**

The U.S. has run deficits almost every year since World War II, with prominent surpluses only in 1998-2001.

Go back a few decades, and the characterizations of the two political parties were fairly well established. The Democrats stood for progressive taxation (meaning a higher percentage burden on top earners) and more government spending, especially in aid of those in need. The Republicans were the party of strong defense, small government, fiscal responsibility and balanced budgets.

More recently, neither party has shown resolute fiscal discipline. Both have added unfunded programs. Tax reduction has been discovered as a growth stimulant. The upward march of our deficit and debt has been nearly uninterrupted.

We've seen the enactment of spending programs without providing for increased revenues to pay for them, and cuts in taxes without corresponding reductions in spending. As President Obama put it on July 15:

> . . . we cut taxes without paying for them over the last decade; we ended up instituting new programs like a prescription drug program for seniors that was not paid for; we fought two wars, we didn't pay for them; we had a bad recession that required a Recovery Act and stimulus spending and helping states . . .

The blame isn't limited to one party. The increases in deficits and debt took place when both Democrats and Republicans were in power, and while control of government was both divided and in the hands of a single party.

It seems apparent that in recent decades, politics has become more partisan, and solving the nation's problems has taken a back seat to adhering to ideology and getting re-elected. And what gets people elected? Promises of more: more benefits without increased taxation, and more take-home pay without reduced largesse. Only recently have large numbers of politicians begun to face the music, admitting that the government has to either do less or charge people more or both.

Obstacles to a Solution

From my point of view, so much that's illogical is going on regarding these issues that I sometimes find it hard to get my head around the current "debate" (if we can call it that when so few people are conversing). Here's what I think is the logic of the situation (with data from *FactCheck*, July 15):

- Expenditures have risen relative to the economy even as revenues have declined.

> Washington's spending has recently been higher as a percentage of the nation's economic output than at any time since World War II. But by the same measure, Washington's revenues are the lowest in more than 60 years.

- The government is spending far more than it brings in. The current deficit is in excess of $1 trillion, and "the U.S. is borrowing about 36 cents of every dollar spent so far this year. It borrowed 37 cents on the dollar last year, and 40 cents in 2009."

- **There's no way to change these facts in the short run**. In particular:

  > The largest components of federal spending are Social Security and Medicare programs for the elderly (33.5 percent of total outlays in 2010) and national defense (20.1 percent). Interest payments on federal debt . . . accounted for 5.7 percent of all federal spending.

  Thus revenues (which equate to 64% of spending) just slightly more than cover the 59.3% of the budget that went for these inescapable expenditures. What about cutting programs that are unpopular and more discretionary? That wouldn't accomplish much:

  > Foreign aid . . . amounts to less than 1 percent of the entire budget. . . . All agriculture programs – including farm subsidies – make up just over one-half of 1 percent.

- When deficit spending is unavoidable, we have to borrow.

- Since we're at the current debt ceiling, continuing to borrow requires that the ceiling be raised.

- If the ceiling isn't raised and we can't borrow, we won't be able to make good on all of our obligations. Someone will have to go unpaid: employees, creditors, soldiers, retirees, vendors, etc. I don't think anyone believes we can make good on all of our obligations without borrowing.

- Thus we have to solve this immediate problem. We can enact spending cuts and/or tax increases, but invariably these things will only take effect over the long run. **In the short run we have no choice but to raise the debt ceiling and keep borrowing.**

*   *   *

- **When the House of Representatives is under the control of one party and the other party is in charge of the Senate and the White House, solving gritty problems requires compromise.**

- A compromise is defined as a solution in which both sides make sacrifices, giving up some of what they want and making concessions to the other side that they find distasteful. On July 14 *The New York Times* cited Sen. Alan Simpson on President Ronald Reagan's pragmatic attitude toward compromise:

  > He had a rule: If you can agree on 80 percent, take it. He raised taxes 11 times in eight years. He did it to make the country run.

- **But compromise runs directly against ideology and is incompatible with lines drawn in the sand.** Some of today's elected officials have pledged not to permit any increases in taxes. Others have vowed to resist any cuts in entitlement programs such as Social Security and Medicaid. **Some even campaigned on explicit promises not to compromise and not to raise the debt ceiling; for people like these, reaching agreement would be a problem, not a solution.**

- Even among Republicans, it seems that some put the highest priority on balancing the budget while others insist on shrinking the government. This creates a fundamental intra-party conflict, since increasing government revenues represents a way to accomplish the former but is in direct contravention of the latter. (See "Anarchists and Tassel Loafers," *The New York Times*, July 14.)

- There's another important difference of opinion; which is more important, adherence to avowed principles or action to address the short-term problem? Many politicians have made public pronouncements that render the two mutually exclusive.

- **Thus to date enough people have refused to accord first priority to solving the debt problem in the short term that a compromise solution has been rendered unreachable.**

*   *   *

- The picture is complicated by the fact that any action to reduce the deficit and related borrowing – be it through reduced spending or increased revenues – would have a depressing impact on an economy that is already anemic.

- Thus many people want to maintain or increase spending or cut taxes to stimulate the economy, even though doing so would exacerbate the problems of deficit and debt in the short run.

- There is considerable disagreement over which would be worse for the economy: a $1 reduction in government spending or a $1 dollar increase in taxes? Economics is too imprecise to produce a definitive conclusion. And economists have ideologies, too; Republican economists tend to describe revenue increases as more harmful, while Democratic economists are more likely to resist spending cuts.

* * *

- If the debt ceiling isn't raised, as I said, some people will have to go unpaid. Among the candidates are our nation's creditors. Failure to pay creditors is called default.

- Some lawmakers believe that, even if the ceiling isn't raised, we'll manage to pay creditors and avoid default.

- At least until recently, and perhaps still, some of those involved have been unconvinced that failure to act would have grave consequences.

> At a closed-door meeting Friday morning [July 15], GOP leaders turned to their most trusted budget expert, Rep. Paul D. Ryan of Wisconsin, to explain to rank-and-file members what many others have come to understand: A fiscal meltdown could occur if Congress fails to raise the debt ceiling. House Speaker John A. Boehner of Ohio underscored the point to dispel the notion that failure to allow more borrowing is an option. "He said if we pass Aug. 2, it would be like 'Star Wars,' " said Rep. Scott DesJarlais, a freshman from Tennessee. "I don't think the people who are railing against raising the debt ceiling fully understand that." (*Los Angeles Times*, July 16)

* * *

- If the U.S. defaults on its debt, our credit rating will likely be cut from triple-A. But there may be people who don't believe this, while others seem unconvinced that it would be a serious development.

- I believe, however, that (a) our rating will be cut if there's a default, (b) this would have serious repercussions for our cost of borrowing, and (c) even if we were able to avoid default and/or downgrade, the feeling that our political leaders had engaged in irresponsible action could reduce lenders' view of our credit and increase our cost of borrowing anyway. **I strongly doubt the dollar can remain the world's reserve currency, of which unlimited amounts are accepted, without unflinching adherence to the associated responsibilities.**

- **Another thing I'm most sure of is that no one knows what the repercussions of default and downgrade would be.** They don't call economics "the dismal science" for nothing. When some people warn of Armageddon, others feel they're exaggerating for effect. There's no way to prove anything on this subject other than by letting it happen.

- Finally, I'm convinced that while it's not certain exactly what will happen if a solution isn't reached, some of the possible results could be very negative.

This situation is incredibly complex and serious. I feel we need a compromise solution, because I'm just not willing to conduct an experiment with consequences that are unforeseeable and could be grave. But the events to date show us that compromise solutions are assured only when there's a broad consensus that an agreement is desirable, and that the consequences of not reaching one are worse than the disadvantages of the compromise. Nothing tells me that such a consensus is prevalent enough to guarantee that the underlying problem of deficit spending will be solved.

<u>The Most Likely Outcome</u>

If you want to get re-elected and suspect that failure to raise the ceiling might hurt your chances – or if you just believe raising the ceiling would be good for the country – you might agree to a compromise in the end. But, given the ideological divide, lawmakers will be more likely to accept a compromise if there's less substance and less teeth in it.

Thus I think a solution will be reached. But given the complexity and difficulty of the issue and the short time remaining before the deadline, it's unlikely to be either detailed or iron-clad. T**he most likely outcome here is a short-term, stopgap solution**. It probably won't require the balanced-budget amendment desired by conservatives, the broad spending cuts Republicans want, or the tax increases Democrats insist should be part of any deal . . . some or all of which we clearly need.

In other words, the "solution" is unlikely to represent much fundamental progress; for the most part it'll just kick the can down the road. It may call for a new commission to study the problem, but:

- the last commission came up with a plan that was hailed by the commission members who were former elected officials, rejected by many of those still in office (who have to face voters), and quickly forgotten, and

- it's hard to believe that the likelihood of a plan being adopted will be greater without the presence of a deadline for raising the debt ceiling, as opposed to lower.

Progress will be touted, but much of it will be illusory. In that regard, I'm reminded of the recently announced solution in the Minnesota budget stalemate. A good part of the financial shortfall was bridged with an agreement to securitize and sell off payments scheduled to be received in the future as a result of the tobacco settlement. But raising money by selling assets doesn't permanently fix an excess of expenses over revenues. That's like selling off manufacturing equipment to save a company that's operating in the red. (Note that one of the things that keeps government from taking a "businesslike" approach to fiscal issues is the fact that government accounting treats spending on capital assets the same as expenses, and the proceeds from asset sales the same as revenues. No business would join in these mistakes.)

Regardless of the exact methodology, I believe that any "solution" announced this month will (a) fail to make fundamental improvement, and thus in the words of Rahm Emanuel will let the current crisis – with its potential to compel real change – go to waste, (b) delay any real action and (c) fail to reduce the likelihood of recurrence of the debt ceiling problem.

*   *   *

What we need is this:

- government expenditures that are limited to revenues, with the exception of isolated instances of deficit spending designed to fight recession, where after the deficits are promptly reversed by amassing surpluses, and

- encouragement for economic growth that enables the pie to grow and government to pay for its activities on a current basis.

Anything else would be a short-term palliative . . . or a continued exercise in imprudence. **Spending that grows no faster than GDP should be an imperative. Shrinking government's share of the economy seems highly desirable. National debt that is stable or declining as a percentage of GDP sounds compelling.**

(In addition to balancing the budget and growing the economy, I think we have to accept that the coming decades are likely to see U.S. standards of living decline relative to the rest of the world. Unless our goods offer a better cost/benefit bargain, there's no reason why American workers should continue to enjoy the same lifestyle advantage over workers in other countries. I just don't expect to hear many politicians own up to this reality on the stump.)

To close, I'm going to borrow some quotations and data from Michael Cembalest, Chief Investment Officer of J.P. Morgan Private Bank (*Eye on the Market*, July 18):

The long-term threat:

> . . . there are serious questions, most immediately about the sustainability of our commitment to growing entitlement programs . . . the time we have is growing short. (Paul Volcker, *The New York Review of Books*, June 24, 2010)
>
> According to the CBO alternative case (tax cuts do not sunset as planned; AMT keeps getting indexed to inflation; no Medicare cuts take place, etc.), by the year 2024, entitlements plus interest spending will be equal to total government revenue. Just 12 years ago, in 1999, the CBO estimated that this would not happen until 2060. The crossing point has moved in by 36 years.
>
> In 1967, the government estimated that Medicare expenses would grow by 7x by 1990 (unadjusted for inflation); they grew by 61x instead. In addition to the lack of cost controls on entitlements, demographic changes are a problem as well: the ratio of workers to Social Security recipients has declined from 17-to-1 in 1950 to 3-to-1 today.

The short-term threat:

> As the largest buyer and holder of U.S. Treasury bonds, we need to seriously assess the risks. We hope that the U.S. government adopts a serious policy to ensure the interests of the investors. (China Cabinet Development Research Center, and the Chinese Foreign Ministry, after the Moody's downgrade watch was announced and S&P reportedly told lawmakers it might downgrade U.S. debt if payments were missed.)

The essential element in any real solution:

> The country is so thoroughly given up to the spirit of the party, that not to follow blindfolded the one or the other is an inexpiable offense. Between both, I see the impossibility of pursuing the dictates of my own conscience without sacrificing every prospect, not merely of advancement, but even of retaining that character and reputation that I have enjoyed. Yet my choice is made; I am at least determined to have the approbation of my own reflections. (John Quincy Adams in his diary, on sticking to his principles and supporting the British embargo, knowing that it would harm his home state of Massachusetts and get him thrown out of the Federalist party)

The world has awakened to the undesirability of ever-growing government debt. Repairing the situation will require difficult decisions and great sacrifices, especially on the part of lawmakers required to vote for unpopular solutions. This would be a great time to start taking positive steps.

July 21, 2011

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Memo to: Oaktree Clients

From: Howard Marks

Re: What's Behind the Downturn?

In May, I observed in "How Quickly They Forget" that investors had returned to pro-risk behavior despite the lingering presence of significant macro worries. And then just three months later, a number of exogenous events caused the markets to undergo a significant decline and one of the greatest paroxysms of volatility ever seen. All of the reasons existed well before. Investors simply hadn't taken them to heart.

I never cease to marvel, and complain, about the way investors flip-flop – focusing on just the positives at one moment and just the negatives at another – and the speed at which they do it. But I learned long ago not to be surprised by this phenomenon or expect it to stop occurring, but instead to look past the market's behavior and assess the underlying realities. Thus I decided to take the occasion of my summer vacation to write a memo parsing the recent events and touching on the outlook.

Confluence

Markets usually do a pretty good job of coping with problems one at a time. When one arises, analysts analyze and investors reach conclusions and calmly adjust their portfolios. But when there's a confluence of negative events, the markets can become overwhelmed and lose their cool. **Things that might be tolerable individually combine into an unfathomable mess whose extent and ramifications seem beyond analysis. Market crises are chaotic, not orderly, and the multiplicity and simultaneity of contributing causes play a big part in making them so.**

That was certainly the case in the three crises we've lived through as investors in credit. In addition to the recession and credit crunch that marked each one, we saw:

- in 1990, the collapse of the most prominent leveraged buyouts of the 1980s; the Gulf War, with Iraq's invasion of Kuwait and the allies' response; and the government's crusade against high yield bonds, Drexel Burnham and Michael Milken;

- in 2002, the aftermath of 9/11, including our invasion of Afghanistan; the unraveling of the overbuilt fiber telecom industry; and the exposure of accounting scandals at Enron, WorldCom and Adelphia and the fall of Arthur Andersen; and

- in 2008, the sub-prime mortgage meltdown; the defrocking of tranching, leverage and derivatives as constructive forces; the outing of credit rating agencies as no more reliable than their models; the banks' major losses in off-balance-sheet investments; and, as a result of all of the above, the collapse or rescue of a number of prominent financial institutions and grave concern about the rest.

It's my sense that it was the simultaneous nature of these occurrences – in addition to, or perhaps rather than, their force individually – that rendered the markets so incapable of maintaining their equanimity.

Certainly that was the case in early August. For the first time in history, the Dow Industrials either rose or fell by at least 400 points four days in a row. What was it that sent the markets on that wild ride? I can think of a number of factors:

- rising awareness of the import of the U.S.'s fiscal deficit, and the bitterly disappointing display that played out in Washington as we approached the date on which the debt ceiling would bind,
- Standard & Poor's downgrading of U.S. government debt,
- increasing worry about Europe's ability to deal with the excessive debts of its peripheral countries, and thus about the health of European banks holding them,
- concern over the possibility of a double-dip recession, and
- mounting evidence that China and the rest of the emerging world are something less than unstoppable economic miracles.

Importantly, we saw the onset of one of those negative feedback loops where intelligence is imputed to market developments. We're told the falling prices reflect problems lying ahead, and thus investors sell in response to the message being provided by . . . investors who're selling.

Again, I think it was the collective force of these things that convinced people the world was a scary place. **What could be worse than the convergence of a number of major worries whose extent, interaction and solution seem beyond comprehension?**

<u>Washington Debt Follies</u>

Where can I start on this sorry subject? As described in "Down to the Wire" in late July, America and the world contemplated the collision of an irresistible force (the U.S. government's need to borrow due to its habit of spending more than it brings in) with an immovable object (the debt ceiling and Washington's seeming inability to reach a constructive solution to it).

With control of the government divided and many legislators committed to preventing either tax increases or cuts in social programs, it was obvious to most level-headed observers that any solution would require compromise. But while it could have been a negotiating stance, several of the participants in the debate seemed not to attach much importance to reaching a solution if it required compromising on their positions. In the process, a disappointing number gave the impression that they didn't understand or care much about the significance of deficits, defaults and downgrades.

On July 27, *The New York Times* ran an article on political negotiating. Its mention of the game of chicken reflected what was going on in Washington: "two players [drive] toward each other, each wanting the other to swerve. The one who does, loses. The trick to winning is for one player to convince the other that under no circumstances will he or she veer off course." One way to do that, *The Times* suggested, is to unscrew your car's steering wheel and toss it out the window. I must say I found that an accurate metaphor for what we were watching. **While that may have been an effective tactic for winning the political game, however, it didn't do much to reassure onlookers hoping for a reasonable solution. Instead, it gave the strong impression that reason couldn't be counted on to prevail.**

Nevertheless, the situation played out as expected. We saw the short-term problem papered over; little movement toward meaningful spending cuts or revenue increases; and the formation of a bipartisan commission to come up with a solution to the long-term problems. But if the plan formulated a year ago by another panel including some of our most eminent former legislators couldn't gain traction, what's the likelihood a new one will fare any better?

Anyhow, the markets breathed a collective sigh of relief and went back to normal when the can was kicked down the road. Investors were hungry for reassurance that Washington was up to solving the problem of deficits and debt and alleviating the uncertainty, but I don't think they got it. **All decisions to invest – whether in factories, new employees or securities – require confidence that there'll be a salutary, stable and predictable environment. Our leaders' response to the debt crisis did nothing to foster one.**

Confidence was further eroded when, a few days later, Standard & Poor's announced that it had downgraded long-term U.S. debt from AAA to AA+, and all hell broke out. Was the downgrade appropriate? What did it mean? And how many of those who reacted in the markets really understood its significance?

According to S&P, a triple-A debt issue means "Extremely strong ability to meet financial commitments. Highest rating." **Certainly the U.S.'s ability to meet financial commitments remains "extremely strong." But is it the "highest"? And is it as high as it used to be, or do recent events suggest it is diminished? I find the issue hard to wrestle with:**

- Given that the U.S. has the power to print the world's reserve currency, it doesn't make sense to think it will fail to pay its obligations. (Of course, if it runs the printing presses to pay its debts, the dollars with which it does so will likely have diminished purchasing power.)

- The truth is that an AA+ rating is far from meaning "default-prone." Since only a few percent of single-B bonds default each year on average, at worst AA+ must imply a probability of default of a small fraction of a percent. In fact, many potential triple-As opt for AA+ instead in order to be able to carry more debt. That's one reason S&P rates only four companies triple-A.

- Getting a little more esoteric, what does it mean for a debtor to "meet financial commitments"? As I mentioned in "Down to the Wire," debtors generally aren't expected to pay off their debts; rather, it's the normal expectation that interest will be paid and principal will be refinanced. **Interesting, then: even triple-A doesn't necessarily connote an ability to extinguish one's debts.**

- While credit ratings are explicitly defined as relative, relating primarily to the likelihood of payment, **I've always thought triple-A has a connotation for most people that absolutely nothing can go wrong. For that matter, U.S. Treasurys have traditionally been described as "riskless," which sounds pretty absolute to me. If that's a fair description, it doesn't seem to fit the political process we've witnessed in the last few months.**

- The events of July suggest some of those currently in control in Washington don't think failing to meet commitments would be a big deal. Certainly it seemed possible on July 31 that some of the people to whom the U.S. owed money might go unpaid within a few days. So, is the risk on Treasurys really non-existent?

- If the U.S. was triple-A in 2000, when it was running a surplus, its national debt was far smaller, and Washington functioned much more constructively, mightn't it deserve a lower rating today?

- Our deficits are far bigger than ever, and the commitment to do what it takes to reduce them seems quite weak. As I wrote in "I'd Rather be Wrong" (March 2010), "Everyone wants to see the deficit narrowed, but today's circumstances seem to prohibit both expenditure reduction and revenue increases. Everything else is on the table." The process of governing seems to be running less well than ever.

- The long-term outlook is particularly bleak. In "Down to the Wire" I described how entitlement programs endanger our fiscal future. I failed, however, to mention that the present value of our future unfunded obligations is estimated at $64 to $99 trillion depending on the source (per J.P. Morgan), a burden that dwarfs our current national debt of $14.3 trillion.

So S&P and Egan-Jones downgraded U.S. debt (while Moody's and Fitch didn't). There was one main moving part on August 5: that's the day S&P labeled U.S. debt less safe. What was the upshot? A buying panic in U.S. Treasury securities, with the yield on the 10-year note falling below 2%.

As an aside, let's spend a minute thinking about that reaction. If there had been near unanimity about anything, it was that a downgrade would raise the yield demanded on U.S. debt. **Certainly the fact that so many people could be wrong about this supposedly simple linkage should disabuse investors of the notion that they know how markets work.** The expected reaction was much more logical than the one that actually played out: after it was labeled less safe, the yield demanded on U.S. debt declined markedly. **I find the explanation fully worthy of Yogi Berra: the downgrade of Treasurys made people so worried about the elevated risk in the world that they ran to Treasurys for safety. So much for the supposed rationality of markets.**

The bottom line for me in all the above is that, while on an emotional basis I find the debt situation depressing, intellectually I believe U.S. Treasury obligations will prove money good. At bottom I agree with former Treasury secretary Hank Paulson:

> While the players in Washington certainly haven't performed at AAA level, I would certainly take U.S. Treasuries over other AAA sovereigns any day." (*The New York Times*, August 9)

<u>The European Version</u>

The problem in Europe isn't overwhelmingly different, just manifested differently. **In the credit boom of the last forty years, debtors all around the world – nations as well as states and cities, consumers, home buyers and buyout companies – borrowed amounts that they couldn't repay now if required to do so. The key questions are whether the loans will be renewed, or who'll pay them off, or how they'll otherwise be discharged.** Only the details vary from instance to instance.

As I described in "It's Greek to Me" (July 2010), for years, especially thanks to their membership in the European Union, peripheral nations with weak economies and little fiscal discipline were able to borrow sums disproportionate to their incomes. Thus Greece, Portugal, Spain and others could run continuous deficits to support excessively generous programs with features such as retirement ages in the fifties and a thirteenth month of pay each year. Lenders were unconcerned about the impossibility of repayment, it seemed, until early 2010. But then they awoke.

Economically stronger nations such as Germany and France, on the other hand, applied much greater prudence. They and their citizens and financial institutions didn't participate as much in the trend toward over-borrowing, and thus don't share the particular problems of the peripherals. But they have problems of their own, since they took the capital piled up by their strong economies and lent it to the profligate borrowers. **Thus the direct problems in the strong nations relate not to unpayable debts, but to questionable receivables**: their banks and other providers of capital are owed large sums lent to the governments and institutions of the peripheral nations.

All member countries are impacted by the general uncertainty present. As in the U.S., the divided, fractious nature of Europe's governing bodies will complicate the process of problem solving. Will the governance structure of the European Union permit a solution to be reached? What can be done about the weaker members? How much of the relief will the strong nations be expected to provide? Will the untested, loose confederation of the monetary union hold together or, alternatively, have to provide for the exit of the weaker links? Will voters in the strong nations allow their elected officials to use resources to support the weak ones?

The basic problems are similar to those in the U.S. in terms of scale, novelty, and the difficulty of identifying solutions. How will the transition be handled from the easy-money environment of the past to the more restrictive one of today? Who will bear the burdens of excessive debt and shoulder the losses? How will the banks' bad-debt problem be solved and their capital rebuilt? Will the political system produce the needed solutions? Are the leaders up to the task? Here's how the *Financial Times* put it on August 20:

> There is no magic medicine and the best solution would be a combination of [several] policies, wrapped up in a show of political will that restored confidence to the global economy. But political will is in short supply, and that may be the most worrying economic sign of all.

If markets abhor uncertainty – as we know they do – then these issues imply little in the way of tranquility. And when multiple problems of this nature coincide, as they did in early August, the result is chaos, at least until the markets become inured to the uncertainty and the gyrations themselves run out of energy.

Possibility of a Double Dip

In 2010 and early 2011, the economic reports suggested a healthy recovery. They contributed to confidence that things were going in the right direction, and thus to investors' feeling of wellbeing and willingness to bear risk. In fact, I expressed in "How Quickly They Forget" my belief that risk tolerance had become excessive relative to the fundamental outlook.

Even when the economic reports were positive, I didn't feel they were as dynamic as in past recoveries. And this one was from the worst recession I've seen, which should have made for a strong rebound. In particular, job growth was slow and unemployment remained at stubbornly high levels.

But then, concurrent with the explosion of uncertainty over debt in the U.S. and Europe, slower growth was reported for the second quarter and the gains of the first quarter and late 2010 were revised downward. All of a sudden, another contributor to the sense that "it's all good" had turned negative instead.

I always hasten to point out that I am not an economist (and Oaktree doesn't have one). **Thus I don't have a strong opinion as to whether the U.S. will relapse into a double dip. (I also have no idea how people reach firm conclusions on such things, other than as expressions of their biases and hunches.) For our purposes, it suffices that we have operated since the financial crisis under the assumption that the recovery would be sluggish, rather than V-shaped. We still feel that way.** And that feeling is inconsistent with moving out on the risk curve or down in credit quality, investing more in cyclicals or taking on leverage.

Our enthusiasm regarding the macro economy has been muted for a number of reasons, including:

- conviction that it was largely the growing use of credit that enabled consumption to grow faster than sluggish incomes over the last 20-30 years, and that in the future credit will not be equally available or equally employed,

- the potentially counter-stimulative effect of austerity as government spending shrinks and taxes rise relative to GDP, and of delevering in general on the part of over-indebted governments, businesses and individuals,

- concern (thus far unfounded) over the potential for rising interest rates and their depressant effect on the economy,

- continuing challenges regarding manufacturing competitiveness due to our status as a high-cost location, and

- belief that unemployment will remain a persistent problem due to the above-mentioned decline in manufacturing, our problems in education, and the shift to an information-based and more productive economy (read: fewer hours of labor per dollar of output).

In addition, we mustn't ignore the part played by confidence. I think confidence is everything in determining the economic future. If participants in the economy believe things will be good in the future, they'll spend and invest and things will be good, and vice versa. **Economic expectations are self-reinforcing in many ways, and right now**

that bodes ill. When people see nothing on TV but news of how bad things are, they tend to pull in their horns. Certainly the recent events haven't been helpful in this regard.

Finally, there's no longer much confidence in the efficacy of the Fed, its chairman and its arsenal. Clearly confidence in Alan Greenspan and his Fed was overdone in his last decade (and thus contributed to the moral hazard of the period). Today the reverse seems to be true, but at least that means we're not burdened with unrealistically high expectations in this area.

On the positive side, many companies are reporting healthy orders and profits. Further, I believe the likelihood or potential severity of another recession is reduced by the fact that economic comparisons now and in the coming months will be against non-dynamic prior periods, and thus relatively easy. In short, without a boom, it's harder to have a bust.

My overall vision continues to be of an airplane rising weakly, perhaps overloaded or with an engine sputtering and thus having difficulty getting above "stall speed." Its sluggishness constitutes a drag and introduces risk, but predicting deceleration is going too far . . . and not necessary to convince us to remain cautious in deciding on our course of action.

Emerging Markets Play Their Part

The emerging markets' contribution to the unsettled environment is of a very different nature. Their economies are growing strongly and generally not over-indebted. Rather, here the issues stem from the juxtaposition – as often seen – of investors' high expectations with a new, less rosy reality.

I've written in the past (e.g., in "Hemlines," September 2010) about the propensity of markets to become captivated by simple themes, like "the Internet will change the world," "equities are good" or "who needs bonds?" One such easy-to-swallow story line that prevailed over the past decade has been with regard to the "emerging market miracle" and, especially, the inevitability of China.

I don't mean in the least to suggest that the outlook for China, India and the rest of the emerging markets is less than bright. In fact, I'm sure they'll out-grow the developed world over the remainder of the century. **The problem, however, is that simplistic, mania-following investors elevated emerging markets to the pedestal of the "sure thing" where nothing can go wrong. And when prices incorporate unlimited virtue, the eventual result is bound to be disappointment, disillusionment and depreciation. Even favorable developments can lead to losses when they fail to measure up to expectations. That's been the case in the emerging markets.**

So now we see:

- concern that the emerging market economies have been over-stimulated,
- the rising inflation that occurs as a consequence,
- uncertainty over whether the monetary tightening which is taking place will result in a soft landing or something worse,
- questions about corruption, fraud, non-transparency and inefficiency, and
- realization – again – that their economic success isn't independent of that of the developed world.

The fundamental outlook in the emerging markets is still excellent. It's just that at times in recent years, when problems arose in the U.S., Europe and Japan, investors turned to the emerging markets for investment solutions, and the view that their future would be "superior" morphed into "flawless." When their securities became priced for that perfection, the realization that they actually had feet of clay – at a time when investor confidence was weakened by the other things I've mentioned – took a toll on investor equanimity and security prices.

Taken Together

None of the issues described above is illusory. The U.S. is a fiscal and political mess, and its leaders inspire little confidence regarding their ability to effect a solution. The outlook in Europe is similarly murky, and the emerging markets have turned out not to be as foolproof as had been believed. However:

- none of these is a new development; they all existed three or six months ago, when the markets were sanguine,
- their scariness is due to the fact that many are relatively unprecedented, and thus the solutions aren't obvious or time-tested, and
- this uncertainty is among the greatest contributors to the markets' unease.

So, as is often the case, the swing we've had is more in psychology than in fundamentals. The positives of June are diminished, forgotten or eclipsed, and now investors are preoccupied with the negatives. As usual, the truth probably lies in between.

We face a new world nowadays in terms of the speed of media coverage, the vast number of outlets competing for people's attention, and in many cases their seeming lack of concern over their own partiality, volatility and non-objectivity. I have no doubt that the media contribute significantly to the manic swing from "it's all good" to "it's all bad," with its highly unsettling effect on the markets. Emotion takes over from reason.

Hysteria rules the day. Nobody knows what the developments mean or what to do about them. But that doesn't prevent investors from acting in response.

With the strong flight to the perceived safety of Treasurys and the pronounced cheapening of everything else, the dearth of bargains that I bemoaned a few months ago is much eased. In U.S. high yield bonds, for example, the yield to worst and spread on the Citi High Yield Market Index went from 6.8% and 526 basis points on May 31 to 8.3% and 719 b.p. on August 31, just three months later. As for European issuers, the yield and spread on the BofA Merrill Lynch Global High Yield ex. Russia Index went from 7.7% and 545 b.p. to 10.0% and 840 b.p. in the same period. Not only are the current spreads well above the historic averages, but the yields are actually quite reasonable in the absolute (and suitable for institutions with 8-ish actuarial assumptions or required returns). And what's been the response? Massive redemptions from high yield bond mutual funds.

So the pattern of the last few weeks hews to the norm:

- There's a period in which the news is good, reaction is favorable, psychology is positive, willingness to bear risk grows, and assets move to higher prices, attracting additional buyers into the markets.

- Then something takes a turn for the worse and, in the most serious downturns, there is a confluence of negative events.

- The worrisome elements gain sway over investor psychology, and the positives are forgotten.

- Disillusionment replaces sanguineness: "How could I ever have put so much trust in the markets?"

- Money flows out of the markets rather than in; it's sellers who influence prices rather than buyers; and securities eventually move from dear toward cheap.

Certainly some of these developments have taken place. **Nobody waves a banner when assets have gotten cheap enough, but it's incumbent on investors to recognize things like these and react appropriately, rather than follow the herd. Thus right now I would be a better buyer, albeit in moderation since fundamentals still pose threats.**

* * *

Rather than end there, as I originally thought I would, I want to add a little about the longer-term future. I could prepare the way by repeating my standard confession that I'm given more to worrying than to enthusing, but you already know that.

What I want to say is this: the worries concerning the U.S. economic outlook enumerated on page seven are not limited to the current short-term cycle. I touched on most of them in "What Worries Me" (August 2008), "The Long View" (January 2009) and "Tell Me I'm Wrong" (January 2010), and my view of their importance hasn't changed. I think they're likely to influence the environment for years.

I feel today's distribution of possible futures is shifted to the left – that is, generally less attractive – relative to the distribution that governed the late twentieth century. The picture in the U.S. is less positive today in terms of consumer-led growth and the supercharging impact of increased credit use, competitiveness and job creation, and the government's fiscal situation (and thus its ability to stimulate the economy).

I think we benefited greatly in that earlier period from the luck of the draw. Things went about as well as they could have for the economy (despite sluggish income growth). Inflation was very much under control, and we benefited from steadily declining interest rates. We were even lucky enough to see the collapse of our great enemy, the USSR, and to live in a world that was generally at peace.

It was a period in which the markets benefited from positive developments and overwhelmingly bullish attitudes. As my partner David Kirchheimer points out, the favorable underlying trends constituted a rising tide in the Buffett sense, meaning for a long time we didn't get a chance to see which borrowers, risk takers and financial innovators were swimming unclothed. The picture has become less alluring with the tides less favorable, and I expect only moderate improvement in that regard.

David adds that "it took many years, trillions of dollars in credit extension, and countless well-intentioned but misguided policies to get us into this mess, so it's likely that under the best of circumstances it will take many years for the economy – and standards of living – to reach a new equilibrium, and for the financial markets to acclimate to a 'new normal' of possibly lower returns without the artificial effect of record government stimulus."

I feel the prosperity we enjoyed in the final decades of the twentieth century was considerably better than "normal," and better than we're likely to see up ahead. I'm not implying a world without growth or otherwise permanently negative. Just one without the prosperity, dynamism or positive feelings of past decades. In addition, the newness of the macro picture and some of the problems – and the opacity of the solutions – certainly make it less clear in which direction we'll go.

It's my belief that things went better in the late twentieth century than we have reason to expect in the years ahead. We could get lucky again, of course, but it would be downright imprudent to make investments predicated on that assumption. **Thus at Oaktree we're making allowance for things that may go less well than they did in past periods. Cheapness provides a margin of safety today, but only so much. We're moving forward, but cautiously.**

September 7, 2011

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Memo to: Oaktree Clients

From: Howard Marks

Re: It's All Very Taxing

The issue is simple: the U.S. government generally spends more than it brings in . . . and recently, a lot more. For years Congress was willing to serially raise the federal debt ceiling and monetize the deficit. But this past summer, some legislators balked. When the early August deadline for an increase in the ceiling arrived, our elected officials kicked the can down the road, but less far than usual. They created a Congressional supercommittee with unprecedented power to propose solutions, and they designed automatic spending cuts in case no proposal won approval.

With the committee working under a November 23 deadline to find ways to reduce the federal deficit by $1 trillion-plus over the next decade, and with a presidential election less than a year away, the subject of taxes is all over the headlines and likely to remain there. Thus I've decided to provide a background piece on the issues.

What form will the deficit-cutting action take? In fact, the possibilities fall into only four categories:

- cut discretionary spending,
- reduce expenditures on entitlements,
- cut waste and fraud, or
- increase tax revenues.

Given the magnitude of the problem, the limited number of potential solutions, and the differences between the parties on the subject, there's already debate regarding the fourth of those listed above. Democrats generally feel tax increases should be part of any solution, and Republicans often insist that while they're open to overhauling the tax code, total taxes must not rise.

<u>What's Fair is Fair</u>

This memo got its start as an excuse for me to write about one of my greatest pet peeves: the so-called "fair share."

Ask your typical Democrat or liberal about the idea of increasing taxes on upper-bracket earners, and what will they say? In my experience, the answer's always the same: "**We're not out to soak the rich. We just want them to pay their fair share.**" We've seen it over and over for years. For example:

> Were [the politicians levying taxes on Americans] seeking to redistribute wealth, to recast society along more egalitarian lines? Or were they simply trying to ensure that rich people paid **their "fair share**"? The answer, predictably, is both. . . .
>
> If poor and middle class Americans were going to be asked [by President Roosevelt], of necessity, to shoulder much of the fiscal burden, then they needed assurance the rich were **paying their share**. . . .
>
> No one made the case more succinctly than Rep. Cordell Hull, legislative father of the 1913 income tax. "I have no disposition to tax wealth unnecessarily or unjustly," he explained in his memoirs. "But I do believe that the wealth of the country should bear **its just share** of the burden of taxation and that it should not be permitted to shirk that duty."
>
> ("Soaking the Wealthy: An American Tradition" *The Wall Street Journal*, January 29-30, 2011)

The rhetoric remained unchanged in the late twentieth century:

> "We will lower the tax burden on middle class Americans," [Bill Clinton] pledged in 1992, "by asking the very wealthy to pay **their fair share**." ("The Middle-Class Tax Trap" *The New York Times*, April 17, 2011)

More recently, President Obama carried on the tradition.

> I will veto any bill that changes benefits for those who rely on Medicare but does not raise serious revenues by asking the wealthiest Americans or biggest corporations to pay **their fair share**. (*The New York Times*, September 20, 2011)

And here's another reference from just a month ago:

> In proposing a 5 percent surtax on incomes of more than $1 million a year to pay for job-creation measures sought by President Obama, Senate Democratic leaders on Wednesday escalated efforts to strike a more populist tone and to draw Republicans into a confrontation over how much affluent Americans should pay to help others cope with a struggling economy. . . .
>
> "It's interesting to note that independents, Democrats and Republicans and even the Tea Party agree it's time for millionaires and billionaires to pay **their fair share** of taxes," [Senate Majority Leader] Reid said Wednesday.
>
> (*The New York Times*, October 6, 2011)

But what is the fair share? How is it to be determined, and by whom? When Senator Reid says, "it's time for millionaires and billionaires to pay their fair share," he implies they haven't been doing so thus far. How does he know? What's the standard? If there's an objective standard for one's fair share, why does it only seem to be those from the left side of the political spectrum who say it's not being paid? And if there isn't an objective standard, how can the fair share be determined? **The truth is, fairness is almost entirely in the eye of the beholder, and "get them to pay their fair share" seems like just another way to say "raise their taxes."**

There's probably only one element of fairness that's beyond discussion: those with higher incomes should pay more in taxes. After that, everything is up for grabs.

- For example, we have a progressive system of taxation, meaning that higher earners don't merely pay more in terms of dollars; they generally pay a higher percentage of their incomes in taxes. Most people agree that this is fair. But is it? Why should success be penalized through greater taxation? And if the tax rate for those who earn more should be higher, how much higher? Should the top marginal tax rate be double that applicable to lower-income taxpayers? Triple? What's fair?

- Are some forms of income more desirable to society and thus deserving of taxation at lower rates?

- And should we encourage certain expenditures by making them deductible from taxable income?

The fairness of all of these things is subject to discussion and disagreement. They come under the heading of tax policy.

Is Taxation Progressive? Progressive Enough?

Under the U.S. system, people in higher income brackets pay tax at higher rates. (However, Mark Twain said, "All generalizations, including this one, are false." For an exception to the generalization above, see the discussion of the "Buffett Rule" on page 5.) **In large part, the question of fairness primarily surrounds whether the higher rates are high enough.**

Talk about "the eye of the beholder." There's evidence on both sides of this debate:

- The top 1% of U.S. taxpayers pay 38% of all individual federal taxes. The top 10% pay 70% of all taxes, the top 25% pay 86%, and the top 50% pay 97%.

- That leaves the bottom 50% of all taxpayers paying only 3% of the total.

- About half of Americans pay no federal income tax, and almost 25% pay no federal taxes at all.

- The average federal income tax rate for the top 1% of Americans is 23% (and for the top half it's 14%), while the average rate for the bottom half is 3%.

Notwithstanding the rhetoric, there's no doubt about the fact that America's top earners are taxed more heavily than the rest. On the other hand, they pay at lower rates than they used to (when I was a boy the top marginal rate was 94%), and it seems progressivity has declined.

> . . . the effective federal tax rate, including payroll taxes, for the wealthiest 0.01 percent of earners fell to 31.5 percent in 2005, from 42.9 percent in 1979 [for a decline of 26.6%], according to data from the Congressional Budget Office. Over the same time, effective rates for taxpayers in the center of the range fell to 14.2 percent, a decrease of just 4 percentage points [or 22.0%]. (*The New York Times,* September 21, 2011)

Total revenues from income taxes have declined in the U.S. – they "are at a historical low of 15.3 per cent of the gross domestic product, compared with a postwar average of 18.5 per cent" (*Financial Times*, September 25) – and they've declined more for top earners than for the rest. This is because of both specific rate cuts that have been enacted and the fact that the rates applied to dividends and capital gains – which clearly flow more to people in the upper income brackets – have declined relative to the rates on salaries and wages.

On average, higher earners absolutely do pay a higher percentage than those who earn less. But the decision as to whether the differential is just right, too little or too great is highly subjective and certainly a valid topic for debate.

<u>Righteous Income</u>

In the U.S., different types of income are taxed at different rates, suggesting some are considered more virtuous than others. For example, profits on investment assets held for more than a year, so-called "long-term capital gains," are taxed less than "ordinary income" such as salaries and interest. This has been the case for so long that we consider it the norm, and what we're used to often becomes the baseline for "fairness."

Long-term capital gains are taxed at reduced rates because of a judgment that long-term investment in things like securities, companies and real estate is beneficial for the economy and should be encouraged. Right now, the top tax rate on long-term investment profit is less than half that on short-term gains and ordinary income. And in recent years, the taxes on dividends have been reduced to similar levels, in part to mitigate double taxation of corporate profits but also because of a judgment that the equity investments that give rise to dividends are good for our society.

Is it appropriate to tax profits on long-term investments at rates below those on other forms of income? Certainly we should encourage investment, but there's no consensus that the tax code is the place to do it. Some foreign jurisdictions don't tax capital gains at all, while others tax them at the same rate as all other income.

What about interest? Why are dividends taxed at preferential rates and interest at ordinary rates? The explanation may lie in the fact that interest is deductible for corporations, while dividends aren't. Interest is paid out of pretax income, while in theory dividends are paid out of after-tax income – although the existence of corporate deductions and credits means dividends may, in fact, be paid out of income that hasn't been taxed by the U.S. Alternatively, the difference in tax treatment may be the result of a desire to encourage investment in "risky" equities rather than "safe" debt. But some companies' dividends are no doubt safer than some other companies' interest payments, so this distinction is questionable. If the goal is to encourage risk bearing, is dividend versus interest the right criterion?

While on the subject of gains from investments, it's interesting to note that, not long ago, dividends were included with interest under the rubric "unearned income." This pejorative phrase implied that income on capital, not requiring labor, was less virtuous than that stemming from labor, so-called "earned income." Thus unearned income – primarily dividends and interest – was taxed more heavily than wages.

But now things have turned 180 degrees, and returns on capital are taxed at lower rates than wages. It's worth noting that the Democrats – commonly considered the party of labor – controlled the government for much of the period 1928 to 1980, when earned income was favored. On the other hand, the Republicans – the party of those with capital to invest – have been in control more of the time since 1980, and the taxation of returns on capital has declined in relative terms. **The definition of virtuous income that should be encouraged through lower taxes clearly is subjective, impermanent and subject to change with the winds of politics.**

One debate that has arisen recently surrounds the so-called "Buffett Rule." For the last few years, Warren Buffett has been speaking about the fact that he pays a smaller percentage of his income in taxes than does his secretary. Presumably this is because his income consists primarily of long-term capital gains and very little of salary, bonus and interest.

(As an aside, it should be noted that Buffett's lower tax rate, while not unique, is far from the norm. According to *The New York Times* of September 24, "The number of people who fall under the Buffett Rule is quite small, only 60,000" out of 450,000 taxpayers who make over $1 million. "And the amount of revenue that would be generated [by the Buffett Rule] over the next 10 years is equally small – just $13 billion. . . .")

Buffett's tax status is a function of policy choices made by the people who wrote our tax laws. According to *The New York Times* of September 21, "President Obama's proposal for a new tax on millionaires . . . would counteract decades of tax reductions for most Americans that have given the wealthy the most benefit. . . ." Do we consider these decisions appropriate in principle and Buffett's just an extreme case? Or do we want to change things so returns on capital are less favored and big earners can never pay overall taxes at lower rates than those who earn less? (And, as an aside, are all long-term profits truly beneficial to society? How, for instance, does society benefit when someone buys a bar of gold?)

Deductions, Loopholes and Tax Incentives

Speaking of gold, in "All That Glitters" on that subject, I quoted from a speech by Mississippi state legislator "Soggy" Sweat that showed his ability to simultaneously praise and condemn whiskey with equal conviction. Outdoing Soggy, depending on who's talking, Washington politicos use the three very different terms above to describe the same thing: offsets to taxable income.

The drafters called them **deductions**: provisions that reduce the net income on which taxes are levied. Critics call them **loopholes**, suggesting there's something underhanded about those provisions. And politicians use the laudatory-sounding term **tax incentives** to describe tax code provisions that reduce tax revenues in order to encourage certain behavior. It all depends on your point of view.

Let's take a look at one of the most popular deductions: interest on mortgages. For as long as I can remember, interest on home mortgages has been treated as a desirable expenditure that should be encouraged. Because home ownership is considered part of the American dream, the tax code subsidizes it by reducing the after-tax cost for those who borrow to buy homes (and are able to itemize rather than take the standard deduction). While everything else may be arguable, certainly this seems fair. But is it?

- Are homeowners more virtuous than renters? If mortgage interest is deductible but rent isn't, we're requiring renters to subsidize owners. Is that appropriate?

- On average, homeowners are from the middle and upper income brackets. Is it fair that poorer renters provide a benefit for richer owners?

- And is it desirable that those able to buy more expensive homes should get more of a subsidy than those consigned to cheaper ones?

As with the taxation of dividends, judgments on these matters change over time. Until 1987, there was no limit on the amount of mortgage interest that could be deducted. If you could afford to own ten homes with multiple million-dollar mortgages on each one, taxpayers would collectively share the cost by reducing your income taxes due. Today interest is deductible on only a maximum of $1.1 million of debt, and only on first and second mortgages, and only on a primary residence and a second home. So the tax treatment of owners of many homes and more expensive homes has become less generous. But it's still better than that of renters. Is that proper?

What about the tax deductibility of charitable donations? As I travel the world visiting with clients, I see that two things about the U.S. are quite uncommon: (a) Americans give a lot of money to charity and (b) donations to charity are deductible in calculating taxable income. Everyone tells me the latter is the main reason for the former. In particular, these things are part of the explanation for the existence of the many private, non-state-supported colleges and universities in the U.S., the best of which are so good at least in part because of their significant donor-provided endowments. For example, Harvard and Yale are only half as old as England's Oxford and Cambridge, but they benefit from endowments that are far larger.

Part of this is true because legislators decided at some point to subsidize non-profits by encouraging contributions through the tax code. That's certainly understandable. And yet, changes were made in recent years to limit upper-bracket taxpayers' use of deductions in order to ensure that they pay some minimum tax rate.

What about the unevenness of the subsidy? The cost of giving $1 to charity is reduced by the amount of taxes it saves the donor, which is equal to $1 times the person's tax rate. So today, speaking simplistically, it costs a top-bracket taxpayer 65 cents to give a dollar to charity, while it costs a bottom-bracket taxpayer 85 cents. Is that fair? Should the bigger earner receive a greater reward for a dollar of philanthropy than someone who can afford it less easily? And should those who aren't inclined to give to charity be required to subsidize those who are?

Finally, what about state and local taxes, the third of the significant deductions? Here tax deductibility isn't due to a decision to encourage people to pay non-federal taxes, but rather to cushion the effect of being taxed in multiple jurisdictions. Texas, Florida and five other states have no personal income tax, California has a heavy one, and someone living in Manhattan pays tax to both New York State and New York City. Deductibility on the federal tax return somewhat evens out the burden and ensures that (a) the states get first crack at taxing income and (b) the federal government can only tax what's left, in line with federalist principles.

This raises a number of questions. Is the deductibility of state and local taxes fair? As with other deductions, the key question is "fair to whom?" Some people pay more state and local taxes than others, meaning they get greater deductions than others. As a result, while a person with a given income who lives in a high-tax state pays higher total taxes, he or she pays less federal tax than someone in a low-tax state. Is that fair?

Further, what all of this means is that by providing more benefits to its residents (or at least spending more money, whether beneficially or not), a high-tax state creates a deduction for its residents and thus reduces the federal government's total tax take. Is this right? Should the federal government subsidize spending on the part of high-tax states? That is, should residents in low-tax states bear part of the expenses of high-tax states? There's nothing simple about these matters.

While the source of an exemption rather than a deduction, what about interest on "municipal bonds" issued by states, counties, cities and local agencies. This is exempt from federal taxation, under the legal doctrine that the federal government mustn't tax the operations of the states. ("The power to tax is the power to destroy," one of our great Supreme Court decisions held.) But here again, we're talking about a federal benefit (in the form of a lower cost of capital) for the biggest-spending local governments and their citizens, and a tax break for people who lend to them.

And what about property taxes? These are deductible without limitation. Thus the owner of a mansion – or ten mansions – receives more of a tax benefit than a low-income earner. And it's another subsidy for homeowners versus renters. Is this right, or should it be changed?

To date, it has been deemed fair for state and local income tax to be deductible on federal tax returns. But is this immutable? Sales tax used to be deductible, too (meaning the buyer of a Rolls Royce got assistance from the federal government). Now it's not. More fair?

What if the deduction for state and local taxes and the exemption for muni interest were ended? This would increase the cost of financing for state and local governments and most impact the highest-spending states, potentially requiring higher taxes causing people to move away. This would reduce those states' revenues and require them to raise taxes further (and drive away still more taxpayers) in a painful cycle. And are those states profligate or just burdened (like California by a substantial low-income population) or natural-resource-poor (lacking Texas's oil)?

So even in "small" matters like the tax deductibility of mortgage interest, charitable donations, and state and local taxes, there are lots of difficult questions. While on their face the deductions seem fair to homeowners, philanthropists and residents of high-tax states, they're simultaneously penalizing renters, non-donors and residents of low-tax states (as well as taxpayers in low tax brackets and those without enough deductions to itemize).

How about the biggest exclusions of all: employer-provided health care and the deferral of taxation of contributions to pension plans? In both cases, those receiving these employer-paid benefits enjoy a substantial benefit not shared by those not fortunate enough to participate. For instance, is it fair that many better-paid workers get thousands of dollars a year in untaxed health-care benefits, while other workers enjoy no such subsidy?

Fairness turns out to be quite an elusive concept.

<u>Reasons for Increasing Taxes</u>

As U.S. leaders wrestle to reduce the budget deficit in the coming months and years, spending cuts are a certainty. But the question of whether taxes should be increased is sure to be hotly debated. A number of justifications for doing so are advanced:

- Some people want wealth to be redistributed throughout society by taxing the rich and giving to the poor. They want the government to do more for those who are less fortunate (or less able), and that means having the rest pay for it.

- There's an argument that for the deficit solution to be equitable, all citizens should contribute to it. Though some government spending benefits all citizens alike, such as national defense, national parks and the administration of justice, much spending disproportionately benefits lower earners, in the form of public education and transportation (which are supported by the federal government), unemployment insurance, food stamps, Medicare and Medicaid, etc. Thus the effect of the coming spending cuts will fall more heavily on the poor. Some argue that since they receive less in benefits and are therefore less likely to experience their loss, the wealthy should share the burden of reducing the deficit through increased tax payments.

- As opposed to the ideological arguments reviewed above, tax increases are among the limited number of possible contributors to deficit reduction listed on page 1. Thus, in the simplest terms, we can cut more from the deficit if we tax more (all else being equal).

- The ultimate practical point is that spending cuts alone won't do much to eliminate the deficit.

- Viewed another way, promises of entitlements have been in place for decades, people have relied on them, and those promises have to be kept. This is clearly impossible without increased taxes and/or exploding deficits.

Is redistribution a valid goal? To some people, it is part of the process of helping every citizen in the "pursuit of happiness." To others, it's akin to socialism and contrary to the American ethic in which rewards follow ability and hard work.

Should everyone contribute to deficit reduction, including bigger earners through the biggest tax increases? Or should the savings come primarily through sacrifices

on the part of those who to date have been the primary beneficiaries of excessive government spending? I have no doubt that we'll see fireworks on these topics.

Reasons for Not Increasing Taxes (or for Lowering Them)

Before concluding that the above points are persuasive, you should consider the equally numerous arguments to the contrary.

- Many believe our massive deficit stems from a government (and an entrenched army of government employees) willing and able to spend all available cash (and more). A bureaucracy will always find uses – many of them wasteful – for available revenues. Thus the only solution is to "starve the beast": only tax cuts and restraints on borrowing will force the government to limit spending.

- It is argued that by decreasing the after-tax proceeds from a dollar earned, tax increases reduce people's incentive to work, and thus cut into a nation's overall productivity. From 1974 to 1979, Britain's top marginal rate was 83% (although with a 15% surcharge on interest and dividends, it could rise to 98%). I remember reading about a banker who took time off without pay to paint his house. Society benefits when each of us does the things we're best at. But if a banker who earns $20,000 a month only gets to keep $3,400, he's better off forgoing a month's salary to avoid paying a painter who gets $5,000 a month.

  Research into the "elasticity of taxable income" (ETI) shows that "when marginal tax rates go up, the amount of reported incomes goes down," suggesting higher taxes do reduce productivity. (*The Wall Street Journal*, March 30, 2010). Of course, it's also possible that when rates go up, the incentives for failing to report income also go up. Thus part of the ETI effect could come from under-reporting, as opposed to reduced effort.

- Taking the above a step further, the "Laffer curve," named after economist and presidential adviser Arthur Laffer, posits that by discouraging work (and thus reducing incomes), raising income tax rates actually reduces income tax collections. Thus, by increasing taxable income, rate reductions bring revenue gains.

- Last but especially timely is the classic Keynesian argument that raising taxes and thus reducing after-tax incomes shouldn't be done at a time when the economy is weak and spending should be encouraged, not inhibited.

For me the bottom line – the real reason why many people don't want rates to go up – is that they don't want to pay more taxes. I think people tend to "vote their pocketbooks," meaning many people with incomes to tax will vote for the candidate who promises lower taxes. **But the economic theories discussed above certainly lend validity and**

even nobility to the pursuit of higher after-tax income . . . and the fact that their supporters are self-interested doesn't make them wrong. Finally, for whichever reason, a good portion of the electorate buys these arguments. And *The New York Times* reported on November 2 that "Americans for Tax Reform, a taxpayer advocacy group . . . says that 41 senators and more than 235 House members have pledged in writing to oppose all tax increases."

Topics in the News – Income Inequality

One of the outstanding characteristics of the U.S. economy at this time is the rising dispersion between incomes. The percentage of total income going to higher earners has been increasing dramatically, whether because of (a) the rising importance of education and technological literacy or (b) the movement of work offshore, the declining availability of blue-collar jobs and the reduced power of private-sector unions to garner wage gains. And given the pattern of tax cuts and the special treatment given to income on capital, the tax system has magnified the divergence.

A recent report from the Congressional Budget Office provided dramatic evidence of the divergent trends in income. It outlined the percentage gain in average inflation-adjusted after-tax income of various income groups between 1979 and 2007:

• Top 1% of the population in terms of income	275%
• Next 19%	65
• Middle 60%	40
• Bottom 20%	18

According to the CBO:

> The share of income going to higher-income households rose, while the share going to lower-income households fell.
>
> - The top fifth of the population saw a 10-percentage-point increase in their share of after-tax income.
> - Most of that growth went to the top 1 percent of the population.
> - All other [quintile] groups saw their shares decline by 2 to 3 percentage points.

An October 26 article in *The New York Times* reported the following conclusions:

> . . . the report said government policy has become less redistributive since the late 1970s, doing less to reduce the concentration of income.

> "The equalizing effect of federal taxes was smaller" in 2007 than in 1979, as "the composition of federal revenues shifted away from progressive income taxes to less-progressive payroll taxes," the budget office said.
>
> Also, it said, federal benefit payments are doing less to even out the distribution of income, as a growing share of benefits, like Social Security, goes to older Americans, regardless of their income. . . .
>
> Also cited as factors contributing to the rapid growth of income at the top [in addition to federal tax and spending policies] were the structure of executive compensation; high salaries for some "superstars" in sports and the arts; the increasing size of the financial services industry; and the growing role of capital gains, which go disproportionately to higher-income households.

The implications for tax discussions are obvious. Upper earners have moved further ahead relative to lower earners, and tax policies have contributed to this trend. **For those who think progressivity should be bolstered, income should be redistributed, and those most able to pay should contribute more heavily to solving the deficit problem, upper-bracket earners make a most attractive target.**

<u>Topics in the News – The Sputtering Economy</u>

In early 2011, there was a growing consensus that the U.S. economy was on an upward trajectory – that recovery had taken hold. Reported growth in GDP was accelerating. Orders, sales and profits were strong. Cash was piling up in corporate coffers. The Fed gave increased thought to increasing interest rates to cool off the economy and prevent the rekindling of inflation.

But in the summer it was reported that the economy had cooled, and earlier estimates of GDP were revised downward. A possible double-dip recession became the topic of the day. At the same time, an unseemly political confrontation regarding the U.S. federal debt ceiling exposed a flawed, unconstructive political system at work; produced a downgrade of long-term Treasury debt on the part of Standard & Poor's; seemed to take us to the brink of a default; and sapped confidence at all levels.

Despite the economy's weakness, further government aid for the economy has been rendered untenable by widespread negative feelings about the stimulus programs of 2007-08 and the popular view that the government took care of Wall Street but not Main Street, combined with the nearness of the next presidential election. **Especially with stimulus unlikely, government actions that discourage growth should be viewed skeptically.**

In the U.S. – just like in Greece and elsewhere in Europe – the answer to problems of excessive deficit and debt can be summed up in one word: austerity. Everyone's after debtor nations to practice austerity; that is, to spend less and tax more. The problem is that such behavior will reduce citizens' incomes, discourage consumer spending and slow or reverse economic growth. While on paper austerity will cut deficits, it may actually add to them by reducing government tax collections. In this way, it would necessitate further borrowing.

There's no doubt that, along with spending cuts, tax increases would have a detrimental impact on the prospects for economic recovery. Thus even people who are open to tax increases may not want them to be effective until the economy is out of danger. As the *Financial Times* put it on October 29, "Many households are so badly overleveraged that a balanced federal budget would ruin them."

But our economic problems aren't just cyclical. There are worrisome secular trends, many surrounding the scarcity of new jobs, the movement of manufacturing overseas, and the low level of business investment in the U.S. **The best cure for our cyclical and secular difficulties would be growth based on industrial expansion.** This would put people to work, support increases in spending, reinvigorate the housing sector, increase tax revenues and shrink the deficit. **But for this to happen, we need (a) tax rates that allow successful entrepreneurs to retain a substantial percentage of the resulting profits and (b) confidence that the tax system won't be made more confiscatory after they've made their investments. At the present time, the latter, in particular, is very much lacking.**

Topics in the News – Flat Tax

It's interesting to note that writers of tax law have two main routes to a given revenue total: low rates without deductions, exemptions and credits, or high rates with them. To date they have chosen the latter course. An article in *The Wall Street Journal* of January 29, 2011 marked down this choice to pure politics:

> Why did [Roosevelt's high tax rates] last so long . . . beginning their long steady decline only during the Kennedy administration? . . . In part to fund the Korean conflict and the Cold War, but also to grease the skids of modern politics. Lawmakers were able to blunt the effect of high statutory rates by handing out tax preferences to their friends, constituents and contributors. Steep rates preserved the appearance of progressivity (and, to be fair, some of the reality), while supplying politicians with their stock in trade: favors.

There are periodic calls for lower "flat" income tax rates and the elimination of deductions and other wrinkles, and we are hearing them today. The main goal is tax simplification. I commend this. (I have to admit that I, with my MBA in accounting, stopped being able to understand my own tax return decades ago.) **But of course we**

cannot convert to a flat tax system without altering people's relative taxes. A change would require sweeping policy decisions.

Flat tax proposals are often accompanied by calls for a national sales, consumption or "value added" tax on spending, such as many other nations have. The problem here is that those with low incomes spend most or all of their earnings on life's necessities, and as incomes rise, people gain the possibility of spending less of their incomes and saving more. Thus sales taxes tend to take a higher percentage of income the lower one's income. That's why, in contrast with progressivity, sales taxes are described as "regressive."

Last month, Republican presidential candidate Herman Cain announced his "9-9-9 plan," which features a flat 9% income tax rate, 9% national sales tax and 9% business tax. Let's take a look at it. The Tax Policy Center is a non-partisan joint venture of the Urban Institute and Brookings Institution. The *St. Petersburg Times*'s politifact.com summarized the results of the TPC's analysis as follows: "83.8 percent of tax filers would get a tax increase . . . compared with current tax policy. On the other hand, most of the tax filers who make more than $1 million would get a tax cut . . . about 95.4 percent of this high income group."

Would it be right to make poor people pay income tax at the same rate as rich people <u>and</u> pay a higher percentage of their incomes in a national sales tax? Anything's fair game, I guess, but if the TPC's analysis is correct, this plan would represent a step away from progressivity and further skew after-tax income toward the wealthy. Yet we're likely to hear a lot more about flat tax during the coming campaign. **When confronted with complex problems, people often welcome simple solutions.**

<u>Topics in the News – Political Posturing</u>

A Democratic politician I know decided not to run for president in 2008 because he expected a rising tide of populist rhetoric to be required. He was right: classist speech rose substantially. And the rise continues unabated.

Democrats tend to lean toward bigger entitlement programs, greater governmental involvement in the economy, deficit spending, progressive taxation and income redistribution. These things are in contrast to Republicans' averred traditions of small government, individual self-sufficiency, free markets, balanced budgets and tax reduction. At the present time, with the economy performing poorly, Democrats are glad to describe Republicans' *laissez faire* policies as having contributed to joblessness and economic hardship. With difficulty more prevalent than prosperity today, populism – appealing to disadvantaged economic classes based on claimed inequities – represents a compelling brand of politics.

Thus in recent months we've increasingly heard Democratic politicians sneer at "millionaires and billionaires" (see Senator Reid on page 2), an epithet aimed at a group that's supposedly been getting away with something. (In the past, I seem to recall, it was instead a group most people wanted to be part of.) To date, the preferred Republican label for people with money has been "job creators," although this line of defense may be tough to maintain in the current climate.

The *Financial Times* of October 29 carried an article headlined "Obama takes high-risk stance against the rich." It described a decision to emulate Roosevelt's Depression-era rhetoric and point an accusing finger at the Republicans as the party of wealth.

> Throwing out the standard presidential playbook dictating an aspirational approach to centrist voters, the White House is cementing a message that strikes at wealth and privilege.
>
> "There is surging sentiment among voters that the economy is weighted towards the wealthy," said a senior White House official.
>
> The White House strategy will make the 2012 election a generational test of the Republican push of the last three decades for cutting taxes, in ways their critics say have been constantly skewed towards the highest earners.

However, the article goes on to say Republicans may respond in kind to this tactic, joining in support of the common man rather than standing up for wealthier supporters:

> . . . Republicans are tweaking their public message, with the hardline [H]ouse majority leader, Eric Cantor, recently acknowledging the need to address the rich-poor gap.
>
> Mitt Romney, the frontrunner in the race to challenge Barack Obama in 2012, has taken to saying that he is standing up for the "middle class" because the rich "can look after themselves."

With candidates in both parties competing to sound less pro-wealth, top earners and their supportive tax policies should expect to be rhetorical targets in the coming election. Whether this will extend to Republican candidates dropping their resistance to tax increases remains to be seen.

<u>The Ultimate Worry: Tyranny of the Majority</u>

The elements that contributed importantly to America's success included economic aspiration, upward mobility and a tax system that encouraged labor and risk-taking. In short, we all could get rich. **As a result**, **both those with money and those hoping to make money were attracted to the idea of low taxes. This made tax reduction a very popular theme over the last few decades.**

But when people without money start to believe they can't make money, there's little to keep them from taking it from those who have it. This represents a threat to our way of life.

As I've written before, I was very impressed when, as a young man, I heard an interesting explanation for America's economic progress relative to Great Britain: "When the worker in Britain sees the boss drive out of the factory in his Rolls Royce, he says 'I'd like to put a bomb under that car.' When the worker in America sees the boss drive out of the factory in his Cadillac, he says 'I'd like to have a car like that someday.' " This tale says a lot about how we achieved our success . . . and also about what we'd better retain if we want to keep it.

The truth is, in a democracy, the lower-earning majority is perfectly capable of voting to confiscate the wealth of the minority. A lot of people have written about this and associated threats to our system:

> "If Sparta and Rome perished," asked Rousseau in his Social Contract, "how can any state hope to live forever? The Body Politick, like the body of a man, begins to die as soon as it is born; it contains the seeds of its own destruction. (*Financial Times*, October 29)
>
> "When men get in the habit of helping themselves to the property of others," warned the New York Times in 1909, "they are not easily cured of it." (*The Wall Street Journal*, January 29, 2011)
>
> Some people regard private enterprise as a predatory tiger to be shot. Others look on it as a cow they can milk. Not enough people see it as a healthy horse, pulling a sturdy wagon. (Winston Churchill)
>
> As Margaret Thatcher famously said, the problem with socialism is that sooner or later "you run out of other people's money." (*New York Post*, January 12, 2011)

The risk is exacerbated today by the fact (as noted earlier) that about half of all Americans pay no federal income tax. This makes me wonder whether our democracy can make good decisions about taxation when half the people are outside the system.

Obviously, it's tempting to many to increase taxes on the rich, seeing it as a harmless way to enhance the welfare of the many at a small cost to the few. But the damage to the U.S.'s success machinery could vastly outweigh the sums confiscated from those who are targeted. **The "fair share" taken from upper bracket earners has to be kept as small as possible if the tax system is to benefit all of our society. The coming debate over tax increases will be very important in this regard.**

There can be no easy solution. Social programs and tax policies have been put in place that will combine with demographic and income trends to create challenging conditions. "The Middle-Class Tax Trap" (*The New York Times*, April 17, 2011) outlined the consequences:

> [Consider] the "current law baseline," a Congressional Budget Office projection in which the Bush-era tax rates aren't renewed in 2012, the Alternative Minimum Tax (which is supposed to hit only the rich but increasingly bites into middle-class paychecks) isn't indexed for inflation, and Medicare payments to doctors are slashed 20%.
>
> With these changes, the deficit drops away in the next 10 years, and more important, it stays manageably low for the decades after that. . . .
>
> This is how the "current law baseline" cuts the deficit: Thanks to inflation and bracket creep, its tax code generally subjects more and more Americans to rates that now fall only on the wealthy.
>
> Today, for instance, a family of four making the median income . . . pays 15% in federal taxes. By 2035, under the C.B.O. projection, payroll and income taxes would claim 25% of that family's income. The marginal tax rate on labor would rise from 29% to 38%. Federal tax revenue, which has averaged 18% of G.D.P. since World War II, would hit 23% by the 2030s and climb ever higher after that.
>
> **Such unprecedented levels of taxation would throw up hurdles to entrepreneurship, family formation and upward mobility. . . .**
>
> They could have ugly political consequences as well. Historically, the most successful welfare states (think Scandinavia) have depended on ethnic solidarity to sustain their tax-and-transfer programs. But the working-age America of the future will be far more diverse than the retired cohort it's laboring to support. Asking a population that's increasingly brown and beige to accept punishing tax rates while white seniors receive roughly $3 in benefits for every dollar they paid in (the projected ratio in the 2030s) promises to polarize the country along racial as well as generational lines.
>
> **The Republican vision for entitlement reform, President Obama said last week, would lead to a "fundamentally different America" than the one we inhabit today. He's right: asking the elderly to pay more for their health care, as [Representative] Paul Ryan proposes to do, would transform the American social contract, and cause no small amount of pain.**

> **But what Obama doesn't acknowledge is that the alternative path could lead to a different country as well – a more stagnant and balkanized society, in which our promise to the elderly crowds out the fundamental promise of America itself.** (Emphasis added)

Will we keep the promise of entitlement programs or cut them back? Given the prominence of entitlements in the U.S. budget, in large part it comes down to that.

Over the last 80 years, politicians in the U.S. created entitlement programs that we cannot afford. Likewise, to varying degrees citizens throughout the developed world have been given promises their governments can't keep. That a day of reckoning would arrive is not news – credible observers have warned of our current problems for decades – but few politicians have been willing to fall on the sword of unpopular solutions.

Whatever action is taken now, it will not be pain-free. The unpayable debts run up in the past will have to be dealt with. And as for the future, there are only three possibilities: the promises will have to be scaled back, the tax burden will have to grow, and/or the deficits will have to be permitted to increase. If nations are to limit deficits – and it seems they may be forced to – there is no alternative to the first two of these. This fundamental truth will constitute a major portion of the public debate in coming years.

Tax policy consists of deciding who to take from (and how much) and who to give it to. There are no easy answers. We should all throw our support behind the common good and not just our individual interests.

November 16, 2011

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Memo to: Oaktree Clients

From: Howard Marks

Re: What Can We Do For You?

We'd love to be able to "do it all" for our clients and give them everything they hope for. It would be great if we could predict what economies and markets will do, move in and out with perfect timing, foresee which industries and companies will fare best, and hold only the securities with the highest returns. **But to paraphrase John Kenneth Galbraith on forecasters, I feel there are two kinds of investment managers: those who can't do these things and those who don't know they can't do these things.**

At Oaktree we've always emphasized being brutally honest – with ourselves and with our clients – about what we can and cannot do. Some managers claim to be able to do it all. Either they really think they can, or they think to be successful they have to pretend they can. The late Amos Tversky of Stanford University made it quite clear which is preferable:

> 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.

In any endeavor involving uncertainty, not knowing what lies ahead isn't nearly as bad as thinking you know if you don't. If you're setting out for a drive and recognize that you don't know the way, you're likely to check a map, follow your GPS, ask directions and drive slowly, watching for indications you've gone off course. But if you're sure you know the way, you're more likely to skip these things, and if it turns out you didn't know, that'll make it much harder to reach your destination.

Rather than commit the error of overconfidence, at Oaktree we consider it essential to acknowledge the limits of our capabilities and act accordingly.

What Can't We Do?

The main thing we can't do is see the future, and particularly the macro future. That simple statement has serious ramifications. It means a lot that we'd love to know is beyond us:

- we can't know what the economies of the world will do,
- we can't know whether markets will go up or down, and by how much and when,
- we can't know which market or sub-market will do best, and
- we can't know which securities in a given market will be the top performers.

And what does the fact that we can't know these things mean for our portfolio management? **Simple: it means we mustn't act as if we can.**

If you could know these things, the path to success would be clear: Stick to markets that will do well and avoid the rest. Concentrate on the individual securities that will be the best performers. Load up when the market's about to rise and get out at the top. And use maximum leverage when the return will exceed the cost of capital and none when it won't.

But what if you can't? You should acknowledge your limitations, enroll in the "I don't know" school of thought, and accommodate your behavior to reality (see "Us and Them," May 7, 2004). The more you acknowledge you don't know what the future holds:

- the more you should diversify, spreading your bets to make sure you don't miss the winners or, more importantly, overload on the losers,
- the less you should attempt to augment performance through adroit short-term market timing, and
- the less you should employ leverage.

The difference in behavior between those who think they can know the future and those who don't is potentially enormous. It's essential to be on the right side of this choice because, as Mark Twain said, "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." That's an essential component of the formula for investment survival.

<u>What Can We Do?</u>

Investing consists almost entirely of making preparations for the future, and I just stated that the future is largely unknowable. Does this mean that there's nothing we managers can do for our clients? No, quite the contrary. Investors who understand reality can restrict their efforts to areas in which they can make a difference and avoid wasting their time (or – even worse – taking unjustified risks) where they can't. In fact, there's a long list of things we can do for our clients despite our lack of prescience:

- **We can highlight potentially fruitful asset classes, strategies and approaches.** Clients generally have no choice but to know a little bit about a great many things. But because specialist managers are supposed to know a lot about a few things, they should be able to identify superior opportunities and the best way to access them.

- **We can help inform the capital allocation decision by describing the attractiveness of our asset classes.** We should know more than others about our markets' fundamental strengths and weaknesses, technical conditions and price attractiveness. This doesn't mean just speaking up when our markets are cheap; it also means admitting when they aren't. **It can't always be "the greatest time" for any asset class.**

- **We can strive to know more than others about companies, industries and securities.** A knowledge advantage is a clear prerequisite for consistently superior investment performance. While we can't know these things with certainty, specialized expertise can help us do a better job of assessing prospects and estimating intrinsic value.

- **We can try to find bargains and avoid overpriced securities.** By applying a disciplined approach to security selection, a manager should be able to judge the relationship between the price of each security and its intrinsic value. This can't be done flawlessly, of course, and at any rate the impact of this relationship on performance is often outweighed in the short run by trends in investor psychology and perception. Thus, like everything else, this won't work every time. But on balance the superior manager should be able to assemble portfolios whose holdings have a higher collective probability of moving in the right direction.

- **We can limit risk.** The risk in investing increases along with the degree to which the future is unknowable. Recognizing this, managers who acknowledge the limits on their foresight tend to incorporate a good measure of risk control in their portfolios. They try to make fewer investments whose success is heavily dependent on knowing what the future holds, thereby creating an increased margin of safety. **This approach to investing shouldn't be expected to maximize return – especially in good times – but rather to maximize <u>risk-adjusted</u> return. This is a mission-critical part of the investment manager's job.**

- **We can control our egos and emotions.** The biggest errors are made when the investing herd is driven by emotion: to buy at the top by greed and excitement, and to sell at the bottom by fear and despondency. These errors are compounded when investors – even professionals – surrender to their egos and overestimate the degree to which their judgments are correct. Superior managers can help their clients by refusing to mirror these flaws.

- **We can act as contrarians.** Given the way the emotion-led consensus is wrong at the extremes as described above, there's money to be made by doing the opposite. Objectivity, insight and ego control are all you need. But it's far from easy. The successful contrarian has to have a sense for what the herd is doing, understand what's wrong with its behavior, resist the emotions driving it and do the opposite – all of this despite being "only human" and thus not immune to the forces driving others.

- **We can behave counter-cyclically.** The cycles in economies and markets conspire to cause investment mistakes. For example, in advanced up-cycles:

    - the economic indicators show gains,
    - companies report earnings increases,
    - assets appreciate,
    - investors enjoy good returns,
    - riskier approaches outperform,
    - leverage adds to gains, and
    - the capital markets eagerly provide financing.

Developments like these encourage investors to behave aggressively. However, the right time to do so isn't when things have been going well, but after economies and markets have declined. But then, conditions make doing them much more difficult. Akin to contrarians, counter-cyclical investors can produce good performance with low attendant risk by doing the right thing at the right time. This, too, isn't easy. But anyone can do things that are easy . . . which don't add any value. Superior managers are supposed to do the things that are hard. **I consider behaving counter-cyclically to be one of a manager's most important responsibilities.**

So there's quite a list of things that should be within managers' capabilities. Superior managers should be able to keep very busy and make a significant contribution to their clients' performance . . . even though they can't know the future.

<ins>Oaktree on Market Timing</ins>

This memo provides an ideal opportunity for me to discuss Oaktree's position on these matters and address some potential inconsistencies.

In the weeks before Oaktree opened its doors in April 1995, my partners and I spent a great deal of time turning the ideas that had guided our actions over the preceding years into the explicit investment philosophy that would govern our new company. We wrote out the six tenets of our philosophy, and we haven't changed a word since. The first two concern the values that we hope we're best known for: risk control and consistency. But questions sometimes arise about numbers five and six, in which we disavow macro-forecasting and market timing. Certainly these disavowals are consistent with what I've said managers can and can't do. But do we adhere to them?

It's plain to see that our tactical approach to our markets varies over time:

- In marketable securities, we open and close for new capital; raise and lower the defensiveness of our holdings; stay fully invested or allow cash to increase modestly; and adjust our allocation to cyclical companies.

- In private partnerships, we raise larger and smaller funds; occasionally organize follow-on "b" funds before their predecessors are fully invested; raise and lower the percentage invested in senior securities; and invest at a rapid pace sometimes and gradually at others.

So it's appropriate to ask whether our behavior is consistent with our philosophy. Can our actions be reconciled with our professed non-reliance on foreknowledge? Or are we really secret forecasters or closet market timers? The questions are simple, but the answer is not.

First, we don't undertake the tactical actions described above in response to what we or some economists think the future holds, but rather on the basis of what we see going on in the marketplace at the time. What kind of things do we react to?

- The simplest signs surround valuation. What's the yield spread between high yield bonds and Treasurys? And between single-B and triple-C? Where are the yields and premiums on convertibles? Are distressed senior loans selling at 60 cents on the dollar or 90? Is the S&P 500 selling at 30 times earnings or 12? These things tell us whether markets – and investor ardor – are overheated or ice cold.

- We find nothing as terrifying as the ability to easily do dumb deals (see "The Race to the Bottom," February 14, 2007). When large numbers of transactions occur that leave us shaking our heads, it's a strong signal that the market is lacking in the risk aversion and skepticism that are needed to keep it safe and sane.

- Equally worrisome is the presence of investor ebullience. When results are good and everyone's certain that more of the same must lie ahead, the pendulum of investor psychology invariably swings to extremes of greed, optimism, confidence and credulousness – the raw material for bubbles and subsequent crashes. I constantly go back to Warren Buffett's formulation: "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."

- It's also troubling if aggressive investment vehicles are popular and over-subscribed. For the value-conscious investor, the seven scariest words in the world are "too much money chasing too few deals." But that's likely to be the case when everyone's certain that each new issue, fund and black box represents the chance of a lifetime.

The key lies in the fact that our strongest actions are undertaken in response to currently observable phenomena like these, not predictions. The way I put it, "we may never know where we're going, but we'd better know where we are."

Second, I confess: I think about the future. So do my colleagues. If someone who's spent decades investing doesn't have opinions about what lies ahead, there's something wrong. I believe our clients want us to apply the benefit of our experience in gauging and reacting to the opportunities and risks that lie ahead.

But I have a mantra on this subject, too: "It's one thing to have an opinion; it's something very different to assume it's right and act on that assumption." We have views on the future. And they can cause us to "lean" toward offense or defense. Just never so much that for the results to be good, our views have to be right.

Here's the full text of the tenets in question. I think you'll see that we're true to the limitations expressed above, albeit perhaps not slavishly.

> <u>Macro-forecasting not critical to investing</u> – We believe consistently excellent performance can only be achieved through superior knowledge of companies and their securities, not through attempts at predicting what is in store for the economy, interest rates or the securities markets. Therefore, our investment process is entirely bottom-up, based upon proprietary, company-specific research. We use overall portfolio structuring as a defensive tool to help us avoid dangerous

concentration, rather than as an aggressive weapon expected to enable us to hold more of the things that do best.

Disavowal of market timing – Because we do not believe in the predictive ability required to correctly time markets, we keep portfolios fully invested whenever attractively priced assets can be bought. Concern about the market climate may cause us to tilt toward more defensive investments, increase selectivity or act more deliberately, but we never move to raise cash. Clients hire us to invest in specific market niches, and we must never fail to do our job. Holding investments that decline in price is unpleasant, but missing out on returns because we failed to buy what we were hired to buy is inexcusable.

You'll occasionally see modest increases in the cash levels in our portfolios. However, they occur largely because we're finding more things to sell than buy, not because we're predicting a market decline. Most of our actions along these lines are micro-driven.

Likewise, we never say, "It's cheap today, but it'll be cheaper tomorrow, so we'll wait." If it's cheap today, we buy it. If it gets cheaper, we'll buy more. Waiting to buy until it gets cheaper could help us avoid a decline, but if we're right about the asset's merit, that decline will prove temporary. On the other hand, if the decline never materializes, waiting will keep us from making a good investment . . . that is, from doing what our clients pay us to do.

So the bottom line is that we walk a fine line between not trying to be forecasters or market timers, but also not being so oblivious to what's going on around us that we miss opportunities to avoid dangerous markets or take advantage of bargains.

Thoughts on Portfolio Positioning

I'm going to use the context of this memo to set out a way of thinking about portfolio structuring that I've developed recently, and to show how I would apply it today. I'm not saying it's an unerring thought process, or the only way to think, but I hope you'll find it potentially useful. I'm sure I'll have more to suggest in the future. But I've been thinking and talking about these things in recent months, and I want to share them here.

The thought process centers on three questions I think an asset allocator should ask each day upon coming to the office:

First, do you expect prosperity or not? Why do I ask? Didn't I say above that investors can't know the future? Yes, I think the economic future is unknowable – that is, that few among us are able to know more than the consensus about what the economy's going to do. And that's especially true at inflection points, when it's important to stop extrapolating recent trends.

But we cannot escape the responsibility for deciding whether to position our portfolios aggressively or defensively, and thus to decide what asset classes and tactics to emphasize.

Doing so requires us to make some gross assumptions about the economic outlook. Again, however, we shouldn't act boldly out of conviction that our assumptions are right.

If the economic environment will reflect prosperity, we might want to put more into growth stocks, cyclical companies, risky assets and levered strategies. If it won't, it might be better to favor value stocks, "real" assets, safer companies and unlevered strategies. Unless we're willing to flatly say we don't know anything about the future and always hold a fixed or "policy" portfolio, we have to try to assess the outlook and adjust accordingly.

Second, which of the two main risks with which investors have to contend should you worry about more: the risk of losing money or the risk of missing opportunities? A skilled investor can eliminate one or the other of these risks, but nobody can eliminate them both. How, then, should one behave? You can put all your efforts into avoiding one risk or the other, but that's imprudent. Or you can maintain a fixed balance between the two, but that seems to excessively ignore variation in the outlook for upside potential and downside risk. Instead, I think the right approach is to adjust your stance as the environment changes.

To me, the answer to this question lies primarily in the degree of cheapness prevailing in the markets. When asset prices are high, there's more risk to be aware of and less opportunity to worry about missing. On the other hand, when prices are low, it's appropriate to worry less about the risk of loss and more about missing out on the opportunities created by those low prices.

Third, what are the right investing attributes for today? Three years ago, at the depths of the post-Lehman crisis, you only needed two things to achieve big gains: money and the nerve to spend it. With prices so low, you didn't need caution, prudence, conservatism, risk control, patience or selectivity. In fact, the more of those things you had, the more you were held back and the less money you made. In that crisis climate, "money and nerve" was enough.

Does that mean money and nerve is always a surefire formula for success? Absolutely not. Think about 2005-07: money and nerve was a recipe for disaster. Then you needed caution, prudence, conservatism, risk control, patience and selectivity. Only if you had a good dose of those things might you avoid the full brunt of the financial crisis that lay ahead.

The formula for success in investing changes, based largely on the conditions in the environment. What are the right attributes for today? Money and nerve, or risk control and selectivity?

These three questions are interrelated and overlapping, and in sum they come down primarily to the choice between offense and defense. Unless you insist on maintaining a constant position in this regard, determining your stance is one of the most important investment decisions.

Portfolio Structuring Today

As I've written in recent years, I don't see a quick return to the prosperity of the past. In the 1990s, for example, we experienced the best of all worlds:

- the economy did well,
- although incomes grew slowly, the growing use of credit buttressed consumers' ability to spend,
- there were great strides in technology and productivity,
- companies reported rising earnings,
- stocks appreciated every year, not by their "normal" 10%, but by 20% on average,
- the wealth effect from growing 401k's added to consumers' willingness to spend,
- interest rates declined continually,
- capital was readily available,
- inflation remained under control,
- faith ran high in the ability of the Fed to keep the economy on a steady path, and
- there was peace in the world.

Now that's good times!

Today, the U.S. economy is doing fairly well, and it should continue to recover in the years ahead. In fact, I think the main immediate risk to recovery stems from uncertainty connected to the European crisis. Will Europe experience a recession (or is it in one already)? Will a European recession cut into America's growth? Will Europe's political leaders prove unable to arrive at and implement the required solutions? Will countries exit the euro and/or reschedule debt? Will uncertainty surrounding Europe's financial institutions impact the U.S. economy and its own institutions?

I'd say "maybe" to all these things. And maybe not. But to me the bottom line is that, regardless of these specifics, the outlook isn't positive enough to call for prosperity or anything approaching the good feelings of the 1990s.

- After spending more than they made for a good while, American consumers should realize the attraction of owing less and having some money in the bank. So maybe for a while they'll spend less than they make. And credit may be harder to come by than it was in the past, similarly limiting credit-fueled consumption. While good for individual balance sheets, these trends will constrain aggregate economic growth.

- The U.S. has its own deficits and debt to worry about. We have to consider the impact on growth of reduced government spending and increased taxes, the same austerity the rest of the world is experiencing. Even without any action on the part of government, significant, already-mandated tax increases and spending cuts have the capacity to impede GDP growth.

- A few months ago there was talk of a double-dip recession in the U.S. We don't hear much about it today, but that doesn't mean it's off the table.

- Nobody can prove that the U.S. won't fall into a slow-growth malaise similar to what Japan has been experiencing, although I believe it will avoid doing so thanks to the spirit of creativity and optimism that remains in force.

Taking all of these things together, I think the probabilities favor slow growth at best, making it unlikely that this is the time for aggressive investment behavior.

On the other hand – and there definitely is an "other hand" – there are significant factors arguing against extreme risk aversion. They relate primarily to market conditions.

First, in many cases valuations are quite reasonable. U.S. stocks, for example, are much cheaper than usual, selling at low absolute p/e ratios. The S&P 500 has failed to appreciate over the last twelve years, while corporate earnings have grown substantially. Thus its p/e ratio has tumbled. The average p/e in the postwar era was 15 or 16, and in 1999 it reached 30. Today it's about 12. Of course there are caveats:

- While equity valuations are down, it can be argued that they're not down enough to reflect all of the deterioration in the secular outlook. Conversely, it's impossible to prove that they are.

- In addition, it's always possible that earnings estimates are too high, meaning stocks aren't as cheap as their p/e ratios suggest.

The one thing I know for sure, however, is that U.S. stocks are cheap versus historic norms.

Another example of cheapness can be seen in high yield bonds. In the 33 years since I organized Citibank's first high yield bond fund, the normal yield spread between the high yield indices and comparable-duration Treasurys has been 300 to 550 basis points. Today the spread is closer to 700 b.p.

History shows that if you invest in the high yield bond indices when spreads go above 550 b.p., you usually outperform Treasurys by a wide margin over the next few years. Thus it's clear that with spreads at 700 b.p., they're priced to outperform. High yield bonds – like stocks – could turn out not to have been cheap enough, but there's no arguing with the fact that they (and senior leveraged loans) are relatively very cheap. (Of course you can't eat relative performance, and the current attractiveness of high yield bonds is very much a function of how low Treasury yields are. Nevertheless, after staring at 2% yields on Treasurys for a few years, 8% seems like a lot.)

So we have valuation on our side in today's markets. What else? The other positive, in my view, relates to the "temperature" of the market. I've often written that the key to understanding what might lie ahead is a sense for what's going on in the investment environment.

- The riskiest things are investor eagerness, a high level of risk tolerance, and a belief that risk is low. That's a pretty good description of 2005-07.

- In contrast, we can take heart when investors are discouraged, risk aversion is running high, and economic difficulty is all over the headlines . . . like today.

Twelve years ago, equity returns were ending one of their best decades ever; p/e ratios were way above the norms; investors were participating in a love affair with stocks; equity allocations had been built up; and no one could think of a reason why the performance of stocks might flag. Now stocks have produced no gain for years, and no one's excited about them, even though they're vastly cheaper. **In 1999, sky-high valuations and investor ardor positioned stocks for a "lost decade." Today, low valuations and investor indifference just might mean they're poised to surprise on the upside.**

Unlike the pre-crisis days, virtually no one is oblivious to the macro risks. Most investors hold modest expectations for the developed economies and for the markets. I think this is quite favorable. To put it succinctly, the potential for investment gains is above average when expectations don't fully anticipate the eventual reality. This potential comes not from a future that will be positive, but from a future – whether positive or not – that is underestimated. Underestimation creates the possibility of favorable surprises and, in general, when things turn out better than expected, markets rise.

At the risk of oversimplifying, I see a long list of macro risks on one side of the scale, and low valuations and joyless investors on the other. Prices are neither so high that we must be hyper-cautious nor so low as to call for aggressiveness. Thus I think it's time to balance defense and offense, and to move forward, albeit with caution. That's what we plan on doing in the coming months, while attempting to execute on my list of the things a manager can do for you.

January 10, 2012

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Memo to: Oaktree Clients

From: Howard Marks

Re: Assessing Performance Records – A Case Study

What are the non-negotiable requirements for accurately assessing investment performance? I'd say:

- a record spanning a significant number of years,
- a period that includes both good years and bad, enabling us to assess performance under a variety of circumstances, and
- a benchmark or peer universe that makes for a relevant comparison.

The other day, at an event for alumni and other constituents of the University of Pennsylvania, president Amy Gutmann reviewed the performance of the university during the financial crisis. In the process, she had some kind words for Penn's Investment Board, which I chaired for the ten years from June 30, 2000 through June 30, 2010. Thinking about it afterward, I realized that I should share with you the story of Penn's endowment and its lessons. Penn has agreed that I may do so. The data is a little out of date, but the lessons aren't.

A Little Background

For roughly two decades starting in the late 1970s, Penn's endowment was led by John Neff, probably the most respected investor of that era, in strict adherence to the principles of value investing. Thus, its fortunes fluctuated along with the performance of that school of thought. It did extremely well in the 1980s, when value beat growth and Penn outperformed the value school, and it lagged a little in the early '90s, when those trends reversed.

Penn's portfolio completely lacked exposure to growth stocks, tech stocks, buyouts or venture capital. Thus it fell behind substantially in fiscal 1995 through fiscal 1999, when it gained 16% a year but the average of its peers gained about 23%. Then, in fiscal 2000, the last year before I became chairman, value stocks stagnated, tech stocks soared, and returns on venture capital ranged well into triple digits. Penn lost 2% while its peers averaged returns in the twenties and those with investments in the right venture capital funds made twice that. Penn constituencies such as alumni/donors and the administration were very unhappy in those years, despite the endowment's high absolute overall return.

Penn appointed its first Chief Investment Officer in the late 1990s and began to diversify the portfolio beyond value. Having been on the Investment Board for a few years, I became its chairman at the start of fiscal 2001. The events of the next decade, along with the decisions made and actions taken, provide a number of valuable lessons.

What Matters?

The first of those lessons is that the ability to ignore relative performance depends on the circumstances and, in particular, the constituencies the performance has to please. Endowments provide an outstanding example of this phenomenon. Intellectually, no one could be unhappy with 16% a year for five years. In fact, the trustees of a private foundation probably would have been delighted with such a return in FY1995-99. But it's harder for an institution with outside constituents, like a university, to dismiss relative performance. Alumni question the management of the endowment, and prospective donors start to say, "I love the school, but it makes no sense for me to make my gift now. I'll hold onto the money, grow it at a rate above what you're achieving, and give it later." No university president wants to be the recipient of that message.

In order to survive and have a chance to produce long-term performance, investors have to live up to their constituents' expectations in the short run. Of course, it's important to inculcate reasonable expectations, or to choose clients who have them. **But ultimately, the manager's job isn't to make money, it's to deliver client satisfaction, so expectations have to matter.** All of us, on both sides of the process, should be sure we know what pattern of performance is expected. How else can we know how satisfaction can be delivered?

As a result of holding a highly idiosyncratic portfolio, Penn experienced performance that deviated – unfavorably – from that of its peers to an extent that became intolerable. This necessitated change.

Do It Now?

Upon starting in on the job, I was immediately confronted by one of the truly classic investment dilemmas: You take on the management of a portfolio, and you just know it's structured wrong in principle. In Penn's case, it was clearly unwise – probably in terms of optimizing risk and return, and certainly in terms of keeping up with peers, and thus expectations – to completely omit the things that had been excluded from Penn's portfolio.

I knew right away that Penn's portfolio should include some exposure to growth, tech, buyouts and venture capital. But the reason their exclusion had become so painful is that they had done so well for a half-decade. **So in principle you should own something, but its price is sky-high. Should you hold your nose and buy at what may be excessive prices? Or should you wait for a correction, at the risk of continuing to underperform if it goes higher** (since we know how often things that are overpriced can continue upward)?

Whenever I'm presented with this dilemma, I trot out a 1957 cartoon from *The New Yorker Magazine* that was reproduced in the *Financial Analysts Journal* in 1975. It's my absolute favorite, and I've been waiting for an opportunity to share it with you:

"To hell with a balanced portfolio. I want to sell my Fenwick Chemical and sell it *<u>now</u>.*"

For me, this cartoon frames the question precisely: Should we do the thing that's right in principle, or should we alter our behavior to reflect today's real-world conditions? There's no one right answer; it goes back to expectations. If it's important to track the competition, you should start to make the portfolio less idiosyncratic, regardless of price attractiveness. But if you care more about absolute performance, achieved with risk under control, you should refuse to buy sky-high assets.

The latter is my preference, and it was reflected in my decision. Penn held off from buying tech and growth stocks. But I had declared my intention before taking the job. To put it in horribly mixed metaphors, **having missed the boat for six years, I said I wouldn't jump on the bandwagon just in time to ride it over the cliff.** I hoped making this clear would condition expectations and provide cover in case our actions initially proved wrong.

<u>Offense or Defense?</u>

The dilemma just discussed relates to the biggest single issue facing anyone tasked with structuring a portfolio: whether to stress offense – trying for high returns – or defense – reducing the likelihood of losses. Of course most investors balance these two things. The question is in what proportion.

Penn's historic emphasis on value investing and its eschewing of bigger potential money makers had a lot to do with defense, especially in the environment of the late 1990s. Likewise, I believe I am known – and I certainly know myself – to be one who usually puts great emphasis on defense. **Would a cautious approach continue to penalize Penn, or was it what was called for under the circumstances? Having fallen so far behind, should we continue to stress defense to avoid losses if the market reversed course, or should we go on the offensive in an attempt to make up the lost ground?**

This question had particular importance at Penn. Given its early history as a commuter school rather than an elite institution like some of its peers, Penn came into the 21st century under-endowed; it ranked only 70th in the country in endowment per student. **So the stewards of Penn's endowment faced a particular dilemma: should we invest conservatively because we can't afford to lose the little bit we had, or aggressively in an attempt to close the gap?**

Again, there's no one right answer to that question, and perhaps there was no one right answer for Penn. But the answer was clear for me: I wouldn't preside over a shift to offense . . . and especially not on the heels of one of the best decades for stocks in history.

Working with CIOs Landis Zimmerman (now at Howard Hughes Medical Institute) in the early years and especially closely with Kristin Gilbertson in 2004-2010, the Investment Board and I led gradual diversification into growth stocks, emerging markets and defense-oriented hedge funds, with an emphasis on managers stressing risk-control. We established an allocation for private equity but implemented it very slowly. We kept an above-average percentage of the portfolio in publicly traded securities. And, importantly, we maintained a substantial allocation to cash and U.S. Treasurys, solely to enable us to meet the need for cash for operations and thereby avoid having to sell assets in a time of depressed prices.

The Results

The performance produced by these decisions was quite predictable. With its low-risk portfolio, Penn outperformed when risk taking was penalized but trailed when risk taking was rewarded. It outperformed when value stocks did well but lagged when more aggressive tools, including leverage and portable alpha, paid off. For the decade overall it lagged the average of its peer institutions by a small margin and exhibited lower volatility. No surprise there. Penn's return was about 5½% for FY2001-10, while most of its peers made 6% or 7%.

But average results don't tell the whole story. It's important to remember one of my favorite adages, about the six-foot-tall man who drowned crossing the stream that was five feet deep on average. In investing, it's not enough to survive "on average." You have to survive on the worst days, when the low points in the market are reached. My decade as chairman provided an outstanding opportunity to see that adage in action.

The Realities of Risk and Return

In late 2008 and early 2009 (in other words, for universities, fiscal year 2009), the global financial crisis presented the greatest sinkhole in eighty years. Those caught mid-stream without life jackets were penalized. Many of Penn's leading peer institutions lost 25-28% that year, while Penn's loss was "only" 15½%. I described Penn's results, loosely speaking, as "the least worst."

Going from the investment arena to the real world of university operations makes it clear that investment risk isn't an abstraction. No, risk isn't just volatility. It's what happens to owners of capital when downward fluctuations occur and principal losses are experienced.

Many of Penn's peers were forced to curtail some of their spending, ranging from hot breakfasts to student aid. Some had to suspend construction projects. There were freezes on hiring and wages. Some put illiquid partnership interests up for sale to raise cash and/or escape continuing funding obligations. And some had to borrow in the taxable bond market to meet cash needs.

Penn, on the other hand, had lots of liquidity and faced little in the way of capital calls. Thus it didn't have to go on the defensive operationally. Instead, it was able to keep hiring faculty, keep giving grants instead of loans, and take advantage of an attractive opportunity to purchase adjacent acreage. The benefits of risk control were made concrete. And the performance of the endowment, the CIO and the Investment Board – and, as I said earlier, yours truly – became the subject of some very nice words.

What If? – Part I

All of the above is history. It presented taxing dilemmas and important choices, but other than as to degree, nothing portfolio managers, CIOs and investment committees don't face routinely. But there are two hidden issues – both somewhat philosophical – that I find far more interesting, provocative and important. They surround questions of timing and chance.

Sometimes investors feel something is going to happen in the period ahead, and that they should do something about it in their portfolios. And sometimes they're right. But rarely do the anticipated events occur as expected, and thus rarely are investors' actions proved correct immediately. Overpriced assets continue to appreciate, and cheap stocks decline further. Even if they do the right thing, very few investors do it at just the right time. **Thus timing – and in particular the selection of the beginning point and end point for studying a performance record – plays an incredibly important role in perceptions of success or failure.**

In his important book *Fooled by Randomness,* Nassim Nicholas Taleb points out how easily random events can make good decisions look wrong and bad decisions look right. Clearly one of the reasons for this is that events don't happen on schedule. I think of investment performance as what happens when events collide with a pre-existing portfolio. **A good decision can wisely anticipate the range of things that might happen, but the one thing that actually happens may not have been one of the ones that reasonably could have been considered highly likely**

– or even possible. Or it may just happen at a time other than when it "should" have. The bottom line is that investors are often "right for the wrong reason," and vice versa.

So the first key observation is this: **I came into the job at the end of a highly bullish period, maintained a cautious approach, and it worked. What if I'd gotten the job two years earlier?** I probably would have done many of the same things. But now my tenure would have included the horrendous FY2000, with Penn's 3,000 basis point underperformance. And it would have omitted FY2009, in which Penn lost 1,200 basis points less than many peers and avoided being hamstrung. If I had led Penn's endowment to take the same actions in FY1999-2008 as it did in FY2001-2010, which is quite likely, I'd be considered a very average chairman . . . at best.

The principle lesson of this tale is the observation that investment timing is imprecise and difficult but extremely significant in terms of outcomes. The bottom line: be understanding when evaluating track records, and refuse to accept the results at first glance. Taleb reminds us to wonder about "alternative histories" – the other things that reasonably, probably could have happened. Doing so isn't easy, but it's essential in any field in which randomness plays a big part.

<u>What If? – Part II</u>

The second philosophical question is similar but even simpler: **what if the global financial crisis hadn't occurred?**

My tenure as chairman of Penn's endowment was marked by my characteristic preference for being able to survive bad times over acting to take maximum advantage of good times. And the worst financial event in eighty years materialized, making that the right approach for the times. **But was I "right"?**

As I said before, during my tenure, Penn underperformed by a bit: 5½% versus 6-7%, a very reasonable sacrifice in exchange for side-stepping the pain of the crisis. But if we take out FY2009, the results for the other nine years were 8% for Penn versus 10½-11½% for its peers. Is that still a reasonable sacrifice?

It was largely the arrival of the crisis – with its influence on the ten-year record and its highly visible impact on university operations – that made my tenure a successful one. But could the crisis reasonably have been anticipated, making my caution appropriate? Or was it unforeseeable and thus fortuitous, meaning I was right for the wrong reason? I wonder about this a lot, in order to derive the significance of my tenure as chairman and learn from it. (If you want to read more about "what if" questions like these, you might enjoy the section called "What's Real?" in my memo *Pigweed*, from December 7, 2006.)

The conclusions of my introspection are as follows:

- I lean strongly toward investing defensively unless asset prices are so low and investors so chastened that less cautious behavior is called for.
- In Penn's position endowment-wise, an emphasis on defense was appropriate.
- The euphoric market behavior of the late 1990s, and especially 1999, made elevated caution particularly compelling.
- It was certainly the events that unfolded that made my actions seem as right as they do.
- The events marking the crisis came largely as a surprise. Although I was increasingly worried in the period from late 2004 through the first half of 2007, I did not foresee the specific events of the global financial crisis of 2008, or its severity.
- Although Penn's approach was generally cautious throughout, we increased the defensiveness of the portfolio significantly in 2006-08. Thus it can't be argued that the portfolio stayed equally cautious all the time and eventually was bailed out by the crisis.

The bottom line – however you slice it – is that a cautious approach was appropriate under the circumstances, and it paid off for Penn. **No strategy works all the time, but defensiveness was right for Penn as things turned out. Lucky or good? It's always hard to tell.**

* * *

A full ten years, but still the results were obviously highly dependent on the vagaries of timing and on some largely unforeseeable events. **Were the actions taken at Penn right? Wrong? Or right for the wrong reason? We should insist on engaging in this kind of examination. Only then can we draw reliable conclusions and hope to improve our decision making.** Let me know if Oaktree can help in this regard.

February 15, 2012

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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.**

<u>The Penalty of Youth</u>

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.

<u>Getting to the Truth</u>

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.**

<u>Go Around, Come Around</u>

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're 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.

<u>One More Round</u>

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 Taqqu 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 <u>equally</u> 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.

*   *   *

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.

March 19, 2012

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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 overvaluations 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 <u>correctly</u>. 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.**

<u>Behavioral Sources of Investment Error</u>

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:

- <u>Bias or closed-mindedness</u> – 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.

- <u>Capital rigidity</u> – 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.

- <u>Psychological excesses</u> – 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.

- <u>Herd behavior</u> – 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.**

<u>A Case In Point</u>

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.

One Classic Mistake

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.

<u>A Big Mistake in the News</u>

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?

* * *

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.

June 20, 2012

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Memo to: Oaktree Clients

From: Howard Marks

Re: On Uncertain Ground

The world seems more uncertain today than at any other time in my life. That's a simple sentence but one with significant implications. And it's not just me. Here's what *The New York Times* said on August 12 in an article about John Bogle, the founder of Vanguard:

> "It's urgent that people wake up," he says. This is the worst time for investors that he has ever seen – and after 60 years in the business, that's saying a lot. . . . "The economy has clouds hovering over it," Mr. Bogle says. "And the financial system has been damaged. The risk of a black-swan event – of something unlikely but apocalyptic – is small, but it's real."

I'm going to devote this memo to the uncertainty in the world and the investment environment and then offer my take on the appropriate strategy response. This will require me to touch on a large number of topics, but I will try to dwell less than usual on each of them. If after reading this memo you find yourself hungry for more, you might go back to "What Worries Me" (August 28, 2008) and "The Long View" (January 9, 2009).

The Macro-Economic Setting

It's my belief that we're going to see relatively sluggish economic growth in the U.S. for a prolonged period of time. My expectations for other developed nations, given their specific issues, are even less positive. (This is a good time for my typical reminder that I am not an economist, and far from all of my observations would be supported by that fraternity. And please note that one of the key tenets of Oaktree's investment philosophy dictates that our investing will not be governed by macro forecasts. We say it's one thing to have an opinion on the macro, but something very different to act as if it's correct. I urge you to consider adopting a similar attitude toward all macro forecasts, especially mine.)

Around 2008 or '09, I had a visit from a senator looking – surprise! – for a campaign contribution. I suppose to make conversation, he asked if I could assure him we were headed for a vigorous recovery. "Forget vigorous," I told him. "I'm hoping for lackluster." I haven't changed my tune.

There's a very human tendency to think things will stay as they are, and if they change, that they'll revert to what we're used to. Most people think of economic growth as the norm; after all, that's been the general rule during our lifetimes. In fact, the global economy has grown nicely for hundreds of years. That's something "everyone knows." But how many people think about where economic growth comes from, and whether it's naturally occurring and inevitable?

Economic growth doesn't just happen. Its vigor depends on a combination of population gains, a conducive infrastructure, positive aspiration and profit motive, advances in technology and productivity, and benign exogenous developments. In many ways and to varying degrees, I think the future for these things in the U.S. is less good than it was in the past. The birthrate is down; our infrastructure is out of date; it's uncertain whether technology can add as much to productivity in the future as it has in the recent past (but perhaps it always is); and mobility up the income curve has stagnated.

I think a lot about the role of deficit spending and credit. In the forty or so years leading up to the crisis of 2008, consumers could grow their spending faster than their incomes because of the increasing availability of credit (and their increasing willingness to make use of it). Likewise, generous capital markets greatly facilitated deficit spending on the part of governments. Economic units around the world were able to spend money they didn't have and thus buy things they couldn't afford. This made a big contribution to economic growth, but few people recognized the negative implications: increased leverage, increased dependency on the continued generosity of the capital markets, and thus increased precariousness. In other words, unwise behavior in the short run led directly to problems in the long run. This is a normal aspect of the economic process.

Few debtors can tap the capital markets today to the same extent they could five or ten years ago. In a radical turn of events, lenders now appear to care about borrowers' ability to repay, and they find some of their customers less than creditworthy. Since almost no borrowers actually have the ability to pay off their debts, this has led to credit difficulties ranging from home foreclosures, to municipal bankruptcies in the U.S., to debt crises in peripheral Europe.

American consumers seem to have concluded that they should owe less (or have found that they can't borrow as much). For whatever reason, the savings rate has risen, suggesting a decline in the propensity to spend all one makes and more. All around the world, there's movement on the part of borrowers – sometimes voluntary and sometimes involuntary – toward austerity (reducing the excess of spending over incomes) or even delevering (spending less than you make and using the surplus to pay down debt).

These trends are healthy for individual borrowers' balance sheets, but they imply reduced consumption and thus are negative for GDP growth. If everyone does these things at the same time, the results can be quite contractionary. Regardless of how you look at it, less use of consumer credit implies less economic growth.

The other specific element that gives me pause relates to confidence. Psychology plays a huge role – perhaps a dominant and self-fulfilling one – in influencing economic growth. In short, if people think things will be good in the future, they'll spend and invest, and things will be good. But if they turn pessimistic regarding the future and go into their shells, refusing to spend and invest, growth will slow down.

Consumers were traumatized by the crisis of 2008: laid off, forced out of their houses, made poorer by market declines, and denied credit. Those who didn't feel these influences directly were still pounded by headlines trumpeting economic weakness, the collapse of financial institutions, the need for bailouts, and malfeasance in the banking and mortgage industries. It could require significant healing before these influences abate.

Much of an economy's resilience comes from what economists call "animal spirits": the bullishness that drives things upward when people's innate optimism, acquisitiveness and tendency to forget harsh lessons are sparked by some bits of good economic news. Right now, with animal spirits largely in hibernation, a reversal of the crisis's trauma may not come easy. But that doesn't mean there won't be one. The U.S. consumer has a tendency to surprise on the upside.

Business investment plays a key role in economic recovery. When managers conclude that consumers are about to resume spending after a downturn, they hire workers and invest in new equipment in order to meet the increased demand they believe is coming. Yet the current recovery has seen little in this regard. I think the prevailing attitude has been, "Let's see how far we can stretch our current capacity before spending to expand it." Or as I heard on the radio the other day, in a report on productivity gains, "Businesses continue to do more with less." Thus companies have built cash hoards, not productive capacity.

Much of this has been attributed to uncertainty on the part of executives concerning the business environment. In contrast to the preceding 28 years of pro-business and pro-free market administrations under Presidents Reagan, Bush, Clinton and Bush, today many business people detect antipathy – or, at minimum, indifference – on the part of the Obama administration, in which the private sector is little represented. In addition, there is uncertainty and anxiety regarding the outlook for the economy, regulation and taxes. All of these things have deterred expansion.

Most recently, concern has shifted to the "fiscal cliff" – the combination of automatic tax increases and spending cuts that will go into effect at the beginning of 2013 if nothing is done before then by the seemingly gridlocked government (more on this later). Finally, most business people probably want Mitt Romney to be the next president, but he's behind in the polls. The sum of these doubts is contributing to the sluggish expansion we're seeing. (Of course, one of these days deferred spending could give way to invigorated investment in capacity.)

It's easy to view problems like these as insoluble and part of a self-feeding vicious circle. When people who are overly indebted reduce their spending, their collective action weakens the economy. The weak economy discourages businesses from hiring and expanding, and thus it stays weak. **It's essential, however, to remember that it can be just as wrong to see things as hopeless as it is to consider an environment risk-free.** One mustn't overreact in either direction.

Potential economic pluses do exist, and they tend to be overlooked in downcast periods like today. These include the incipient housing recovery; the possibility of energy self-sufficiency; the fact that U.S. manufacturing has slimmed down and our Chinese competitors have seen costs rise; and the fact that the U.S. still leads in higher education, creativity and entrepreneurship.

For me, the bottom line of all this is that we aren't looking at a period of prosperity. A recovery is underway and is likely to continue, but it is more likely to be lackluster than vigorous. Most Americans' financial memory consists of V-shaped recoveries and periods of good feeling like the 1990s, when they couldn't think of reasons not to borrow and spend. Five years from now, I think people will still be asking, "When will the economy get going? When will we get back to good times?"

Black Swans, Landmines and Long-Term Problems

In addition to this unexciting general outlook, I (like most others) can reel off a litany of current and potential problems like I've never seen before. Each one deserves a memo, but – as I said – I'm trying to be economical with your time and attention.

- **Europe** represents a problem of enormous proportions, huge risk and limitless uncertainty. The nations and banks of Europe – and especially Portugal, Italy, Ireland, Greece and Spain (the PIIGS) – partook liberally of the excessive ability to borrow described above. They squandered the proceeds in a variety of ways, ranging from excessive benefit programs for citizens to ill-fated investments. They owe amounts they can't ever repay and will have trouble servicing in times of economic weakness. They'll be forced to spend less in the period ahead, but that will further weaken their economies and add to the pain felt by their citizens. The results have included unrest and may continue to do so. And yet – despite attempts at austerity and delevering – in many countries the ratio of total public and private debt to GDP is now greater than it was five years ago (according to Jamil Baz of GLG Partners).

  People ask all the time what will happen in Europe. I tell them the situation is enormously complex, murky and uncertain, but I'm absolutely sure of three things: (a) I don't know, (b) nobody knows, and (c) if you ask an expert for advice and follow it, you'll probably be making a mistake.

  When people invest in an Oaktree fund, it's on the basis of a limited partnership agreement that spends a few pages on what we're going to do and dozens more on things like the rules we'll follow and what happens if we don't. I get the impression that in the case of the European Union, politicians wrote the first section based on glowing hopes but forgot about the rest. When faced with conditions like these, in my view, there's absolutely no alternative to saying we have no idea what the future holds. Period.

  Since the nuts and bolts stuff was omitted, there's no schematic diagram or instruction manual for Europe. There are no procedures for ensuring nations don't run excessive deficits, or for moving a member state out of the European Union. Any actions that are taken will require unanimous decisions on the part of elected officials from nations with divergent interests. Taking all of this together, I feel there can be no certainty about:

  - what should be done to fix the problem,
  - what can be done,

- what will be done, and
- what the ramifications will be, especially the second-order consequences.

I imagine Europe's leaders will muddle through, continuing to do the absolute minimum that suffices at the last possible moment. There will be palliatives, but solutions will be hard to achieve (the latter would require the nations of Europe to significantly surrender sovereignty). Last week the European Central Bank announced a program of bond buying, and this was viewed positively. Buying bonds will keep borrowing costs down for as long as it's practiced, but it won't solve the problems. The important tasks facing the peripheral nations are much greater: cutting deficits and policing them, reducing the excessive debt burden that was allowed to build up, and restoring growth and competitiveness. Thus the problem is likely to drag on for years, assuming it doesn't flare up into a global crisis. Everyone hopes Europe will do what's needed, but hope isn't much of a plan.

- **The U.S. fiscal situation** is less acute, less immediate, and easier to duck given that we can print the world's reserve currency . . . but little better. In fact, in some ways it is more dangerous because the problems are more back-end loaded and perhaps less overt.

  Our politicians, too, used easy money to give everyone everything: generous benefit programs as well as significant tax reductions (and major stimulus programs when needed). Entitlements, interest and other mandatory expenditures consume all of the taxes collected; forget about the rest of government spending – on things like defense, education, transportation and scientific research. We face huge annual deficits and ballooning national debt.

  As an aside, one reason our deficit situation isn't worse today is the ultra-low level of interest rates, which constitute a tremendous subsidy of the government by savers. Even with these low rates, interest on the federal debt consumes roughly 10% of all federal taxes collected. Imagine what the deficit would be if the 10-year Treasury note were at 7% rather than less than 2%.

  Entitlement programs are the biggest problem, primarily Medicare (healthcare for the elderly), Medicaid (healthcare for the poor) and Social Security (retirement benefits). Politicians in years gone by granted benefits without much thought to the rate at which they would grow and where the money to pay them would come from. Benefits have been expanded or indexed to inflation, and the post-war Baby Boomers, with their much-increased life expectancies, are bound to create an incredible burden; the national debt of $16 trillion is dwarfed by unfunded future benefits, the present value of which is variously estimated at an additional $50-90 trillion.

  We have problems at the state and local level, in addition to the federal. The federal government is pushing burdens off to states and reducing funding; at the same time the soft economy is cutting into state and local tax collections and increasing citizens' needs. I recently read about a city that had to choose between policemen, firemen and teachers for the layoffs through which to balance its budget. In other words, the city has been providing a level of services that it can't afford. Painful austerity is unavoidable; neither firemen, policemen nor teachers can be easily dispensed with. Also, for years state and local politicians have promised public employees retirement and health benefits without regard for how they would be paid. Pension plans that are currently underfunded by $1-3 trillion represent a ticking time bomb. We've seen a spate of municipal bankruptcies this year, and I believe more are coming.

- **The depressing state of politics** deserves special mention among the problems we face. Having acted in the past to create unfunded, ballooning benefit burdens, politicians – albeit a new crop – now largely refuse to agree on action to reduce them. And no one seems to be penalized for failing to find a solution.

  Just as the need for unanimity will frustrate Europe's attempts to solve its problems, U.S. politicians seem to value things like "ideological purity" (i.e., toeing the party line) and being reelected above real attempts at problem solving. They say they want to solve the deficit problem, but tax increases are off limits for many; cuts in entitlements are anathema for others; there isn't enough discretionary spending left to cut in order to solve the problem; and "compromise" has become a dirty word.

  In 2010 a group of active and retired politicians – the Simpson-Bowles Commission – was asked to come up with a solution. Eleven of the eighteen members supported a responsible proposal including, of course, some pain, but there wasn't the fourteen-vote supermajority needed to formally endorse it. Congress and the White House let it die of inattention. Despite the enormous danger presented by our current and future deficits, too few were willing to touch matters representing the "third rail" of American politics.

  Of course, it's not just the politicians. Many voters say they prefer elected officials who will refuse to "desert their principles" (that is, compromise with the other side in pursuit of a solution). While some voters may understand the risk presented by entitlement programs, most reject any reduction of their own benefits.

  Paul Ryan, the Republican nominee for vice president, is a "fiscal wonk" who cares about the deficit and has a "Ryan Roadmap" to shrink it. Here's what he says on the subject:

  > Washington has not been telling you the truth. If we don't reform spending on government health and retirement programs, we have zero hope of getting our spending – and as a result our debt crisis – under control. (*The New York Times,* August 12, 2012)

  Ryan was chosen for the ticket because his hawkishness on the deficit and overall conservatism were expected to appeal to the Republican "base." But ironically, Ryan's interest in reforming entitlements may constitute a disadvantage on the campaign trail, requiring some serious backtracking. Too many people simply vote their wallets: self-interest usually trumps ideology. While we can disagree with Ryan's approach, we should applaud the rare politician who is willing to tackle this unpopular subject.

- Given the way "inflation hawks" on the Federal Reserve Board resist stimulating the economy when a recovery is underway, there's **concern over the ability to count on further stimulus**. However, I expect the Fed to keep interest rates low for a prolonged period of time and/or undertake other stimulus actions. Recent statements from Chairman Bernanke leave little doubt on this subject. On the other hand, just as I think a lot of economics is determined by psychology, so do I believe a lot of the impact of stimulus programs is psychological. Interest rate cuts, and bond buying programs like QE, have shock value when first announced, but I think it diminishes over time. In the end, it's not easy to make an economy grow when people aren't thinking expansively.

- Today's low interest rates, engineered by the central banks, mean that investors are consigned to doing business in a **low-return world**. Interest rates near zero on T-bills, and yields of 1-3% on Treasury notes and bonds, set the base from which the prospective returns on investments entailing risk are established. And because that floor is so low today, even with healthy risk premiums added, the absolute prospective return on many investments isn't nearly what it was in the past.

- The long-term competitive position of the U.S. is threatened by our **deteriorating infrastructure** in areas like education, healthcare and transportation (as well as trends that are enabling other nations to catch up to us in these regards). These are things that made America great following World War II, but there seems to be little will (or money) to restore them to previous levels.

- In my view, **growing income inequality** is a significant problem. The difference in incomes between those at the top and those at the bottom has risen dramatically, and the ability of those at the bottom to move up the chain has declined. Tax rates applied to income on capital (capital gains and dividends) have been cut relative to those on labor. Finally, everyone knows more than ever about how well the people at the top are doing. A lot of America's economic success has stemmed from the fact that people in the lower income brackets felt the system would allow them to move up through hard work. To the extent that becomes less true – and the outlook today is guarded, especially given the low quality of public education – there can be negative ramifications for society overall.

- **The world of today seems full of intractable challenges**. Think about the list of actual and potential problem areas: Iraq, Afghanistan, Iran, Israel/Palestine, Syria, Pakistan, North Korea, and occasional flare-ups in former Soviet republics. In contrast, the period from the fall of the Berlin Wall (1989) and the USSR (1991) up until the attacks on September 11, 2001 seems like a halcyon one largely free of conflicts considered capable of destabilizing the world. The comparison is stark and troubling.

- The last big element of uncertainty on my list is the **outlook for China**. In the years leading up to today, what characterized China?

    - underused resources, largely human, and low manufacturing costs,
    - an economy directed centrally, not by free market forces,
    - rapidly growing financial resources,

- a strong desire for economic growth and industrialization in order to move the population to the cities and upward in economic terms,
- the need to respond to the global financial crisis of 2008 and the non-performing loans it produced,
- an expectation that manufacturing would expand without limit as China supplied goods to nations around the world as well as its own growing consumer class, and
- resulting certainty that China couldn't miss.

The upshot of all of the above was massive provision of capital in order to advance China's economic development and urbanization. State-owned enterprises were created and expanded, and infrastructure building was accelerated. Residential construction, in particular, took place at an elevated rate.

This may have been yet another instance where too much money led to bad capital allocation decisions. China's modern era had seen only growth, not cycles of boom and bust. Even when the central government wanted to rein in the rate of building, local governments – which derive a lot of their revenue from sales of land for development – were not similarly motivated. Chinese individuals faced very limited options for investing their capital: bank interest was below the rate of inflation and thus negative in real terms, and foreign investment was prohibited. This combination drove large-scale investment into either properties or savings products known as "trusts," the proceeds of which flowed into fixed asset development. Thus the process went out of control. Good intentions around urbanization and infrastructure development fell victim to massive speculative capital flows. The consequence was excessive fixed investment.

(One great way for authorities or central bankers to stimulate an economy is by providing capital for residential construction. This results in increased employment and spending on materials and components. When the economy heats up in response, however, a housing bubble often ensues. Home prices rise and speculative buying follows. The only thing missing is end-buyers for the unneeded or unaffordable homes. It's particularly interesting to note that excess residential investment contributed in a major way to the recent problems in China, Ireland, Spain and the U.S. In all four countries "Potemkin villages" of new homes grew up, suggesting economic vigor . . . but standing empty.)

In China's case, capital wasn't withdrawn by external lenders. Rather, the central planners decided it was time to reduce stimulus. In this way leverage would be reduced, the rate of fixed asset investment would ease, and the economy would be kept from overheating and inflating. However, as has been seen throughout history, planned economies tend to defy the planners, and cycles are hard to modulate.

China's economic growth has slowed, and living with declining growth has turned out to be no easier in China than elsewhere. Worldwide economic weakness and cost-advantage-eroding inflation have reduced the demand for Chinese exports, a main prop supporting China's economy. It has been made clear that (a) internal consumption isn't enough to give China's economy the growth it needs and thus (b) China isn't without dependence on the rest of the world. **It has yet to be determined whether China's landing will be soft or hard.**

And if China lands hard – in part because of weak demand from the rest of the world – will its weakness feed back, further weakening those nations from which China buys raw materials and finished goods? The world's economy is complex, interrelated and interdependent. China is a major example of this and, at this moment, a contributor to worldwide uncertainty.

So what do we find? Economic fragility throughout the world, I think, as well as a number of factors capable of exacerbating the situation in the short run or keeping it weak in the long. I can't remember a time when no jurisdiction was considered completely safe for investment, but that seems to be the case today. When people enthuse about the U.S., it's usually only in relative terms: "the best house on a bad block."

At the University of Chicago in the 1960s, I was taught that U.S. Treasury bills paid the "risk-free rate of return." Nowadays most investors have trouble thinking of anything as riskless. When I talk to investors, most of them snicker uncomfortably about the proposition of even U.S. Treasurys being entirely safe.

Is There No Good News?

Isn't there anything on the positive side of the ledger, capable of balancing against the weak fundamental picture described above and making investment attractive? A few things deserve mention, I think.

The first is **the possibility that things won't turn out to be as bad as I describe.** Because of the impact of psychology on people's thought processes, it often turns out that things aren't as bad (or as good) as they seemed at the extremes. But since I'm not a big believer in macro forecasting, I don't believe there's a way to prove that my negativism isn't fully warranted.

The second is **the fact that asset prices are reasonable in many cases, at least relative to other investments or to history.**

- In 1999, when everyone was unworried, the S&P 500 traded at more than 30 times earnings. Today the p/e ratio has more than halved, and it is well below the post-World War II average. In addition, dividend and earnings yields on equities are unusually favorable relative to the yields on bonds. There's no doubt that stocks have cheapened relative to historic parameters – although the case can also be made that they aren't cheap enough, since future growth is unlikely to be at the historic rate.

- Yield spreads on high yield bonds relative to Treasurys are at levels that historically have been considered generous and have consistently given rise to subsequent returns well above those on Treasurys. In other words, the reward for accepting credit risk via high yield bonds is at a level that in the past has more than compensated for the credit risk entailed. Although there's far less historic data, the same seems true of senior loans and mezzanine debt.

- Real estate prices have corrected from the peak of 5-6 years ago and are largely back to the pre-bubble levels of a decade ago. Residential real estate prices are well down from the peak, and the same is true for commercial real estate in all but a half dozen first-tier cities.

And why is this true? Because of the third factor: **investor psychology that is much curtailed from pre-crisis levels**. This is very healthy from a buyer's point of view.

<u>The Psychological Environment</u>

These are uncertain times – there's no doubt about it. The macro outlook is quite unclear, and the level of investor confidence is commensurately low. This reminds me of something that happened – in the larger, non-investment world – eleven years ago this week.

I was in New York on 9/11, and I experienced the uncertainty, fear and confusion firsthand. When I finally got to California several days later, I sat down with my son Andrew, then fourteen years old, to make sure he was okay given what had transpired. He asked me, with his usual perceptiveness, "Dad, is the world less safe than it used to be?" The right answer came to me: "Maybe it's less safe than it used to be . . . and maybe it was never as safe as people thought it was." **Similarly, the macro future seems far more uncertain today than at any time in my experience, but there's a good chance it was never as certain as people thought.**

In the 1980s and '90s, everything went right. Economic growth was strong. Companies thrived. There were great gains in productivity and technology. Profits rose dramatically. Interest rates declined. Inflation was quiescent. Equities soared. Houses and 401k accounts appreciated, producing a positive "wealth effect." The world was largely at peace. All of this contributed to positive psychology, feeding back to further spur economic strength in a classic virtuous circle. Was this a period in which favorable outcomes were entirely dependable, or just one in which the underlying processes met up with good luck, producing favorable outcomes? And if the latter, were the results better than people should have expected to continue?

Regardless, people did extrapolate them. When stocks returned 20% a year in the 1990s, rather than the normal 10%, investors ratcheted up their return expectations for the subsequent years, and with them their allocations to equities. **Everyone knows that if you reach into a bag containing both black and white balls and pull out ten white ones in a row, the probability has increased that the next one will be black. But in the investment world, events like that serve to convince people that there are only white balls – favorable outcomes – in the bag. That's part of the illogical, emotional thinking that makes for bull markets and bubbles.** So by the time the late 1990s rolled around, many investors had concluded that the world was a benign place in which profits were inevitable. That is, that there was little risk or uncertainty.

<u>It's my firm belief that the riskiest thing in the investing world is widespread belief that there's no risk</u>. Usually that dangerous condition stems from excessive conviction that the future is knowable and known . . . and benign. Today there's very little of that. I think that's a substantial positive.

It was one of the outstanding characteristics of the pre-crisis period of 2005-07 that most people were sure they completely understood (a) what made the economy work, (b) what the world would look like in five or ten years, and (c) how things could be fixed if problems arose. Today very few people feel that way. There's nothing pleasant about the transition from feeling you know something to realizing you don't.

But the risk in an activity doesn't stem just from the activity itself, but from how people approach it. When equipment is developed that makes mountain climbing safer, people change their behavior in ways that make it more risky. Equally, much of the risk in investing stems not from securities, companies or exchanges, but from investor behavior. **In short, risk is low when investors behave prudently and high when they don't.**

A world that's perceived as safe can be rendered unsafe if the perception of safety causes investors to move out the risk curve, bid up prices, or take actions that assume greater certainty than turns out to be the case. I think that perfectly describes the years leading up to the crisis. **Conversely, an uncertain world can be safer than people perceive if their concern causes them to behave cautiously (and especially if it causes them to sell down assets to prices from which the likelihood of further declines is reduced).** Certainly few people in the world today are oblivious to the litany of outstanding negatives.

Please note, however, that while investor ardor and risk-blindness are at reassuringly low levels today – and that may be the best single thing that can be said for the current environment – the actions of central banks to minimize interest rates have served to force investors out on the risk curve in search of return. They may not be blind to the risks, but many are participating in pro-risk activities nevertheless. I refer to these coerced participants with a phrase from my late father-in-law, Sam Freeman: "handcuff volunteers."

<u>The Role of Macro</u>

These days we hear little about anything other than macro considerations. Security movements are highly correlated, meaning investment returns are more a function of broad market movements than individual security characteristics. And market movements are, in turn, primarily in response to macro developments.

Thus investors believe more than ever that the route to investment success lies in correct judgments about the macro future. This has given rise to so-called "risk-on, risk-off" investing, consisting of investors' attempts to profit by increasing their risk exposure when they expect favorable macro developments, and decreasing it when they foresee unfavorable developments. Since macro events determine most of the results, it's on the macro that investors believe they should spend their time.

I couldn't agree less. Playing the market in the short term based on macro forecasts is one of the many things in investing that could add greatly to results if it could be done right . . . but it can't, certainly not consistently.

The expected value from any activity is the product of the gains available from doing it right multiplied by the probability of doing it right, minus the potential cost of failing in the attempt multiplied by the probability of failing. Investors are often blinded by the potential gains from a tactic and thus don't think much about the likelihood they can get it right. Because I think so little of the ability to make correct forecasts – and especially of the ability to get the timing right – I dismiss attempts to benefit from short-term macro judgments.

The best response when seas are choppy is to focus on completing the long-term voyage and not think about whether the next wave is going to push the nose of the boat up or down. Our investment destination is best reached by accurately valuing assets, assessing the relationship between price and that value, and acting resolutely and unemotionally when mispricings are detected. That's still the best – I think the only – reliable path to investment success. Nothing about the current environment alters that one bit.

<u>Some Thoughts on Strategy</u>

While I don't believe in short-term tactical adjustments based on macro expectations, I do think clients, portfolio managers and strategists should take macro conditions into account when positioning portfolios for the medium term. And while I'm a big skeptic regarding forecasting, I think we can't ignore the long-term secular outlook. (Is that an inconsistency? Absolutely!)

On January 10 of this year, I sent out a "clients-only" memo called "What Can We Do For You?" It has since been posted to the website, and I hope you'll take a look at it. I said in that memo that I had come up with three questions that might help in setting strategy.

- Do you expect prosperity or not? A simple, not-necessarily-precise judgment on this subject can strongly influence our choice of investment media and approach. As described at length above, it's my conclusion that we won't soon see a return to the prosperity of the pre-crisis years.

- Of the two main risks in investing, which should you worry about more today: the risk of losing money or the risk of missing opportunities? Certainly today's macro uncertainties argue for worrying about loss. But even as the low-return climate suggests we needn't give much thought to opportunity costs, the near-zero returns offered on the safest investments (and the moderate level of asset prices) argue for assuming some risk in the pursuit of a more satisfactory return.

- What kind of investing attributes should you employ today, aggressive or cautious? As above, I feel the pros and cons are balanced, and thus so should be our behavior.

On one hand, we face a lackluster general economic outlook and the threat of further negative developments that could be impactful but hopefully are not overwhelmingly likely. On the other, these worries may be offset to a degree by the lowness of asset prices and investor psychology. The former elements argue strongly against aggressive investing, but the latter – and the low promised returns on highly safe investments – argue that one's investment program should include some forward movement.

When I attended the University of Chicago it was very fashionable to use the qualifier *ceteris paribus*: "all other things being equal." So I can flatly state that, *ceteris paribus*, an outlook characterized by slow growth, potential serious problems and great uncertainty should call for (a) more fixed income investments than equities, (b) more pursuit of value today than growth tomorrow and (c) more safe investments and less use of leverage.

However – and it's the biggest possible "however" – all else is far from equal today. Safe investments have been bid up, such that the returns available on them are paltry at best. If you buy the ten-year U.S. Treasury note today at 1.7%, it's hard to imagine environments other than depression and deflation in which you'll be happy with the outcome. So one of the more important conclusions is that this isn't a black-and-white world in which it's reasonable to insist on safety and eschew risk. **Unless you consider loss avoidance overwhelmingly important and can truly forgo making money, the approach for today has to balance risk aversion and the pursuit of return**.

Moderate investment expectations are an important element in setting one's course. Anyone who insists on returns like "the good old days" is heading for trouble. A somewhat reliable return in the high single digits or low double digits to mid-teens would represent an outstanding result today. I would counsel against trying for much more – or at least that any attempt to do so should be recognized as entailing some very real risk.

What should one do when faced with the conditions confronting us today? I think the smartest response still consists of investing in well-priced corporate securities and income-producing assets. Corporations still have the best chance of adjusting to environmental phenomena such as inflation, dislocation and competition.

An obscure 1958 book, *Corporate Bond Quality and Investor Experience* by W. Braddock Hickman, is said to have given Michael Milken a lot of his inspiration to popularize high yield bonds and foster new issue and secondary markets for them in the 1970s. In his book, Hickman reports on the performance of corporate bonds between 1900 and 1943. He shows that the lower a bond's quality and rating, the higher the return from holding it.

This is a very important conclusion. Aside from arguing for high yield bond investing, it shows that even in this period, which included the Great Depression, corporate bond investing was quite successful. What that tells me is that despite the extremely tough economic climate, many corporations were able to make money and service their debt. This supports my belief that corporate investing represents an attractive strategy for uncertain times.

*   *   *

The simplistic view says that because the world is uncertain today, we shouldn't venture forth. But I think it's much wiser to say that despite the uncertainty, we shouldn't automatically settle for assets believed to be entirely safe – especially since (a) flight of capital to their seeming safety has rendered their promised returns low and (b) that safety can prove to be illusory. Instead we should attempt to take control of our fate and strive for reasonable returns with the risks handled responsibly.

And one of the most interesting aspects of investing stems from the fact that you can't just do nothing. **In the investing world, even doing nothing is doing something.** It's choosing to stay with what you have rather than switch to what you could have. It's deciding to deal with the environment passively rather than actively. And it's avoiding the risky to stay with the seemingly safe. These are significant actions, and they must be undertaken on the basis of serious analysis and active decision making.

The challenge today is that while you can get less-than-safe things relatively cheap because the crowd is desperate for safety, the crowd's concerns are not imaginary. If you turn up the risk because you think the premium being paid for safety is too high, there are scenarios under which you will have made a big mistake. Because the probability of those scenarios occurring is materially above zero, we can't dispense entirely with caution.

The presence of arguments on both sides renders strategy setting difficult today. But when all the arguments are on the same side, making the choice clear, that clarity can lead the investing herd to create a bubble or a crash. Thus our criterion for moving ahead can't be that the way forward has to be obvious. I'm going to repeat what Charlie Munger told me about investing a couple of years ago, even though I used it in my last memo, too: "It's not supposed to be easy. Anyone who finds it easy is stupid."

The outlook certainly isn't so propitious (and assets aren't so cheap) as to call for investing aggressively. But at the same time, market conditions tell me this isn't a time for hiding under the bed. "Move forward, but with caution" -- that's my mantra today. The environment is uncertain, but we shouldn't find that paralyzing.

September 11, 2012

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Memo to: Oaktree Clients

From: Howard Marks

Re: A Fresh Start (Hopefully)

For years I kept these memos away from anything related to politics. But more recently I began to discuss issues facing the United States, and this has required some mention of policy and thus of politics. I've tried very hard to be non-partisan, with a goal of not having readers know my leanings. I hope I've succeeded; at least no one has complained. (But lots of people deceive themselves regarding how unbiased they are, and I may be one of them.)

Because I found America's recent presidential election – and especially the results – so fascinating, I'm going to move explicitly to the field of politics, but with the same goal of non-partisan expression.

The Votes Are In

To me, the most interesting statistics are these:

- Obama beat Romney by less than three percentage points. That's more than most people projected, but still a modest edge. It's a narrow win relative to the long-term history of our elections, but five of the last thirteen were closer.
- Four years ago, Obama beat his Republican rival by 9.5 million votes.
- This year, he got 6.8 million fewer votes and won by only 3.5 million votes (meaning Romney pulled in 0.8 million fewer votes than McCain did in 2008).
- 7.6 million fewer votes were cast in total this year, even though there must now be several million more eligible voters in the U.S. than there were four years ago.

What do these things mean?

- For months I've been asking people, "Among those who voted for Obama last time, how many are disappointed?" Clearly the answer turned out to be, "A lot." (Note that many of the people who did vote for Obama may also have been disappointed, but not enough to not back him.)
- Despite that disappointment – and the persistent high level of unemployment – Obama still won. Many voters apparently saw him as the better choice between two unexciting candidates.

Behind the Numbers

On November 9, *The Wall Street Journal* ran an interesting article entitled "U.S. Voting Numbers Show Changing Nation." It suggested a number of observations relating to voting trends.

- While Obama and Romney received similar numbers of total votes, few sub-sectors of the electorate were closely divided. The *Journal* listed a number of voting groups where Romney had commanding leads: white, male, older, working-class, and rural and small-town. In contrast, Obama owes his victory to strong, sometimes overwhelming majorities among other groups: Latino, African-American and Asian-American, female, younger, college-educated, unmarried, and urban and suburban. **Clearly, at the margin, the two candidates' constituencies were very different demographically.**

- When I think of the Romney-leaning groups listed above, I'm reminded of a 1930 painting by Grant Wood titled "American Gothic." It shows an older white couple standing in front of their obviously Midwestern farmhouse, with the husband holding a pitchfork. I think the typical Republican voter of this last election is nostalgic for that era and wants that America back. The problem the Republican Party faced in this election is that America is moving away from that demographic, not toward it.

- Immigration is an important aspect of life in America and a significant political issue. Our immigrant populations are large and are growing faster than our non-immigrant populations (note, however, that almost every "non-immigrant" is descended from someone who wasn't born in the U.S.). Immigrants who have become U.S. citizens and thus are eligible to vote have a hard time with candidates who adopt a punitive stance toward illegal (today's politically correct term is "undocumented") immigrants. But a strong stand on illegal immigration is among the things demanded by a vocal and significant segment of the voters who choose the candidates in Republican primaries. **Immigrants tend to be more religious and conservative (in the everyday sense of the word), and thus they might be expected to vote Republican. But right now the Republican Party is denied a huge percentage of their votes.**

- There are significant ironies in some other groups' voting patterns. I usually expect people to "vote their pocketbooks" and support the candidate most likely to enhance their financial well-being. But this year's results show that's not always the case.

  - Voters over 40 years of age supported the Republican ticket, which placed great emphasis on curtailing retirement and healthcare benefits (although avowedly not for today's senior citizens).
  - Voters under 40 came out more for the Democrats, even though the young pay a lot today for the entitlement programs Democrats are protecting for older citizens, and the day when they'll benefit from them is far off.
  - Lower-income, less-educated voters – who are unlikely to progress far up the economic ladder – gave majorities to the Republican candidate, with his promise to protect the wealthy from tax increases.
  - College graduates and higher-income whites – with their greater probability of achieving big incomes – came out for the Democratic candidate, who considers it essential to raise tax rates at the top.

- The *Journal* makes the point that "Republicans enjoy historically high levels of control over governorships and state legislatures, which they say shows the party's potential if it can improve its message to minorities." What I think it shows is that, unsurprisingly, traditional Republicans can win state and local elections in traditional states, and highly conservative Republicans can win elections in highly conservative states. **The challenge the party faces lies in uniting behind a single candidate for nationwide office who can win in both.** As long as the two Republican factions are unable to agree on a candidate who appeals to the huge number of independents in the middle of the political spectrum, the Republicans will be swimming upstream.

When you put it all together, you see challenges and conundrums. Right now, the voting trends and demographics make it seem as though the Republicans will be out of power for a long time to come. But

I've seen many pendulum-like swings in politics in my life, and I'm sure we'll see many more in the battle between the left and the right for the middle-of-the-roaders who decide American elections.

It's the Weather, Stupid!

In a curious aside, consider these facts:

- According to CBS, 41% of voters said in an exit poll that Hurricane Sandy had played a significant role in their choice between the two candidates. 26% said it was "an important factor" and 15% said it was "the most important factor."

- Presumably most of the people who said they were influenced by Sandy were expressing a positive view on Obama's handling of it. (It's hard to imagine the logic under which Sandy would have caused someone to vote for Romney.)

If you believe the exit polls, people who were positively influenced by the handling of Sandy could have made up all or more of Obama's 2.8% margin of victory. If it's true that Sandy was the deciding factor for 15% of the electorate, and if it caused just a fifth of those people to switch to Obama, that means without Sandy, Romney would have won. I find it shocking that the choice of a president for four years could turn on something as fickle as the weather.

College Daze

How did the "too close to call" headlines of the days just before the election turn into a resounding victory, which the Democrats will argue has given them a mandate to lead? How did Obama's small edge in the popular vote turn into a 62%-38% margin in terms of the electoral votes that determine the winner? The answer lies in the peculiarities of our electoral college.

I was traveling in Asia and the Middle East at election time, and I found myself having to explain a system in which:

- In all but a few states, 100% of the electoral votes go to whoever wins the popular vote there, regardless of the margin.
- Most of the 50 states – this year it was roughly 43 – are considered "uncompetitive," meaning one party or the other enjoys a substantial, dependable majority. For that reason, a vote for a Republican is totally meaningless in a Democratic state like California, as is a vote for a Democrat in Republican Utah.
- On the other hand, the electoral system gives voters in a few states disproportionate influence. Since the uncompetitive states' electoral votes are not in play, elections are determined by only the few so-called "swing" or "battleground" states. In fact, this year many people thought the election might be determined largely by who won in just one state: Ohio.
- Perhaps most glaringly, a candidate can be elected president with a majority of electoral votes despite having received fewer popular votes than another.

Our system was designed in the eighteenth century to centralize the job of choosing a president in the hands of a few wise leaders and avoid the uncertainties associated with a widespread and uninformed populace with which it was hard to communicate.

But in the twenty-first century, with the impediments to a meaningful popular election much reduced, it's time to reassess the benefits of the electoral college – it's hard to say what they are – versus the costs in terms of potentially weird outcomes. **In the days just before the election, it seemed that for the second time in twelve years we could have a president who'd lost the popular vote. That tells me it's time to reassess our system of voting.**

The First Order of Business

What do you think of when you hear the word "Greece"?

- An uncompetitive, low-growth economy,
- for years, a higher credit rating than it deserved,
- the resultant ability to borrow money it shouldn't have been able to, at interest rates that were unjustifiably low,
- excessive public spending,
- generous benefit promises that it can't fulfill given the realities and, as a result,
- soaring debt and deficits.
- Consequently, the need to cut spending and increase taxes, and
- mandated austerity and delevering, with very negative implications for economic growth.

Now ask yourself what you think of when you hear the words "United States." Certainly the facts aren't the same: our economy is the world's greatest (although not what it used to be), and we can print the world's reserve currency, which Greece certainly can't. But there are similarities. The situation in the U.S. isn't a repeat of Greece's but, as Mark Twain would have said, "it does rhyme."

The truth is that the U.S. has pressing fiscal problems, stretching as far as the eye can see:

- in the short term, the "fiscal cliff," in which already-mandated tax increases and spending cuts have the potential to take 4% off of GDP if nothing is done about them within the next six weeks,
- in the medium term, trillion-dollar deficits unless there's radical improvement, and
- in the long term, entitlement promises that absolutely cannot be met. (With millions of Baby Boomers entering their senior years and living longer, we cannot afford the pensions and healthcare benefits that have been promised. The math is inescapable. If these programs are left unchanged, Social Security benefits will grow inexorably, and spending on healthcare has the potential to escalate without limitation.)

The bottom line is that if we don't want to be Greece, we can't act like Greece. Something has to be done . . . and soon. Every year in which we add another trillion dollars to the national debt (and tens of billions to the annual interest bill) – and every year the excessive entitlement promises are allowed to compound – makes it harder to solve the problem.

Vote "No" on Gridlock

Political conservatism is associated with a desire for a small federal government, and that often leads to a preference for a divided government and the gridlock that goes with it. The argument is that since government doesn't do much well, we're better off if gridlock prevents government from doing much.

People are entitled to a preference for inaction if they view things that way, but I'd venture that inaction is desirable only when conditions are benign. I wouldn't want to see the government paralyzed by gridlock if we were attacked militarily, or if an epidemic needed fighting, or if we were on the edge of a depression, as I think we were in 2008. And I believe strongly that the fiscal problems outlined above need solving; they won't go away by themselves.

Our debt and deficits will recede only if we do some or all of the following:

- cut spending
- reduce waste
- reform Social Security, Medicare and Medicaid
- raise taxes
- speed up economic growth

In theory, even a gridlocked government can take action against waste, but I think the idea of big savings from doing so is largely an impossible dream. And conservatives would eagerly argue that the best way to foster growth isn't for government to take action, but for it to get out of the way of the free enterprise system (I don't fully disagree). But, especially to solve the shorter-term problems, I think we need progress on the other elements, and that will require constructive decision making in Washington.

The opposite of gridlock is compromise. That's what we need today. **Compromise, however, doesn't mean one party saying "We get all we want and you get none of what you want."** Deals like that can only be inked if one party holds all the cards: either the White House plus majorities in both the Senate (and preferably the 60 votes required to stop a filibuster) and the House of Representatives or, at minimum, majorities in both houses of Congress and enough votes to override a presidential veto. Both parties are far from that today, and that may remain the case for a long time.

No, compromise means, "We get some of what we want and you get some of what you want." In practice, it means elected officials have to vote for things they promised to fight and give up on things they swore to deliver. Unless you do that, the other guy doesn't get any of what he wants – meaning he has no reason to go along. This is a reality that our political leaders have failed to confront and accept.

While compromise comes at a cost, gridlock can cost more. Last year, some long-term U.S. debt was downgraded after a particularly unseemly battle over the federal debt ceiling. This occurred not so much because of our fiscal situation, but because our dysfunctional government showed itself to be unable to rise to the occasion and solve problems.

Help Wanted

In past big-picture memos, I have discussed some of the threats to American industrial performance in the years ahead, the dim job prospects of those not suited to work in the Information Age, and my belief that Americans will have to get used to declining relative standards of living.

On November 7, *The New York Times* carried an excellent article by Thomas L. Friedman entitled "Hope and Change, Part II." In it, Friedman did a great job of outlining some of the things Washington will have to do in order for the outlook to improve.

> The next generation is going to need immigration of high-I.Q. risk-takers from India, China and Latin America if the United States is going to remain at the cutting edge of the Information Technology revolution and be able to afford the government we want. . . .
>
> . . . my prediction is that the biggest domestic issue in the next four years will be how we respond to changes in technology, globalization and markets that have, in a very short space of time, made the decent-wage, middle-skilled job – the backbone of the middle class – increasingly obsolete. The only decent-wage jobs will be high-skilled ones.
>
> The answer to that challenge will require a new level of political imagination – a combination of educational reforms and unprecedented collaboration between business, schools, universities and government to change how workers are trained and empowered to keep learning. It will require tax reforms and immigration reforms. America today desperately needs a center-right Republican party offering merit-based, market-based approaches to all these issues – and a willingness to meet the other side halfway. The country is starved for practical, bipartisan cooperation, and it will reward politicians who deliver it and punish those who don't. . . .

I'm frustrated when I see Americans of both parties failing to punish – or even encouraging – behavior on the part of their elected officials that is fractious, partisan, ideological and non-compromising. Gridlock and inaction won't solve our problems. Cooperation, adaptability and Friedman's "imagination" must be the watchwords for the years ahead.

We need constructive action to solve the many problems we face, and there's only one way for it to materialize: bipartisanship.

<u>Signs of Spring</u>

While I was on my recent travels, several people asked me to suggest a potential catalyst for better markets. There isn't any mystery. **I felt (and feel) the clearest answer lies in bipartisan action to resolve our fiscal crises, starting with the fiscal cliff.** In that connection, John Boehner, Speaker of the House of Representatives, gave a noteworthy speech the day after the election. I'm going to quote some of the encouraging statements here (highlighting my very favorites).

> The American people have spoken. They have re-elected President Obama. And they have again elected a Republican majority in the House of Representatives. **If there is a mandate in yesterday's results, it is a mandate for us to find a way to work together on solutions to the challenges we face together as a nation.**
>
> My message today is not one of confrontation, but of conviction. In the weeks and months ahead, we face a series of tremendous challenges – and a great opportunity. . . .
>
> The American people this week didn't give us a mandate to do the "simple" thing. They elected us to lead. They gave us a mandate to work together to do the best thing for our country.
>
> We know what the best thing would be. It would be an agreement that sends the signal to our economy, and to the world, that after years of punting on the major fiscal challenges we face, 2013 is going to be different. It would be an agreement that begins to pave the

> way for the long-term growth that is essential if we want to lift the cloud of debt hanging over our country. . . .
>
> . . . the American people . . . expect us to solve the problem. And for that reason, in order to garner Republican support for new revenues, the president must be willing to reduce spending and shore up the entitlement programs that are the primary drivers of our debt. . . . For purposes of forging a bipartisan agreement that begins to solve the problem, we're willing to accept new revenue, under the right conditions. . . .
>
> **The president has signaled a willingness to do tax reform with lower rates. Republicans have signaled a willingness to accept new revenue if it comes from growth and reform. Let's start the discussion there.**
>
> I'm not suggesting we compromise on our principles. But I am suggesting we commit ourselves to creating an atmosphere where we can see common ground when it exists, and seize it. . . .
>
> **Mr. President, this is your moment. We're ready to be led, not as Democrats or Republicans, but as Americans. We want you to lead -- not as a liberal or a conservative, but as the President of the United States of America. We want you to succeed.**
>
> **Let's challenge ourselves to find the common ground that has eluded us. Let's rise above the dysfunction, and do the right thing together for our country in a bipartisan way.**

"We want you to succeed." Wow!

As a point of contrast, two years ago, another Republican leader said, "The single most important thing we want to achieve is for President Obama to be a one-term president." That was full-contact politics at its worst, with a goal not of solving the nation's problems, but of winning the next election. Speaker Boehner's remarks are 180 degrees from that . . . and all we could ask for at this point.

I'm not a cynic. I want to believe Speaker Boehner means what he says. The important thing is that a spirit of cooperation exists. Hopefully the details can be worked out (although the two parties are at absolute loggerheads on the subject of raising taxes on big earners, and no one should underestimate the difficulty this presents). I am encouraged for now, and I'm going to stay that way until given reason not to be.

<u>President Obama's Reply</u>

I'm proud to share the news that on the strength of my memos, I have been asked to craft a response for President Obama on this subject. I include my first draft below. (Actually, there was no such request, but I've done it anyway.)

> Ladies and gentlemen: I am speaking to you tonight, not to revel in victory, but to chart a course for progress. Not to assert just the goals of my administration and my supporters, but to describe what we're going to get done for all the American people, and how.

In our first term, we took stimulative actions that rescued our country from the threat of depression, and we fought to enact a controversial program that will make healthcare more readily available. There's far more we didn't get done, and much of that was because of a lack of bipartisanship in Washington.

A lot has to be dealt with in the next four years. The list starts with handling the fiscal cliff looming ahead and goes on to include a large number of economic, social and international issues. The basic facts in Washington are unchanged by the election. Democrats occupy the White House and possess a slender majority in the Senate, but we're in the minority in the House and our numbers in the Senate aren't sufficient to cut off debate. Thus control of government continues to be divided. That means progress will be grudging and limited unless we can resurrect a genuine spirit of compromise.

For me to succeed in my job under these circumstances, I must recognize that almost as many people voted for my opponent as voted for me, and that there are almost as many Republicans in the Senate as there are Democrats (and more in the House).

Thus I promise not to act as if only our ideas have merit, or as if only our principles are valid. In order to win support for the things we think are most important, we will make room to the greatest degree possible for the things our colleagues across the aisle deem important, as long as the overall result moves our country in the right direction.

What matters most isn't winning elections, it's doing right for America. I believe the party that does more of that will win most elections anyway. The end will be won if the means are right. You have my pledge that they will be.

That's the best I can do. The rest is up to our elected officials. As my British friends say, "fingers crossed."

November 19, 2012

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Memo to: Oaktree Clients

From: Howard Marks

Re: Ditto

Here's how I started *Whad'Ya Know* in March 2003:

> I always ask Nancy to read my memos before I send them out. She seems to think being my wife gives her license to be brutally frank. "They're all the same," she says, "like your ties. They all talk about the importance of a high batting average, the need to avoid losers, and how much there is that no one can know."

The truth is, anyone who reads my memos of the last 23 years will see I return often to a few topics. This is due to the frequency with which themes tend to recur in the investment world. Humans often fail to learn. They forget the lessons of history, repeat patterns of behavior and make the same mistakes. As a result, certain themes arise over and over. Mark Twain had it right: "History doesn't repeat itself, but it does rhyme." The details of the events may vary greatly from occurrence to occurrence, but the themes giving rise to the events tend not to change.

What are some of my key repeating themes? Here are a few:

- the importance of risk and risk control
- the repetitiveness of behavior patterns and mistakes
- the role of cycles and pendulums
- the volatility of credit market conditions
- the brevity of financial memory
- the errors of the herd
- the importance of gauging investor psychology
- the desirability of contrarianism and counter-cyclicality
- the futility of macro forecasting

Most or all of these have to do with behavior that's observed in the markets over and over. When I see it recur and want to comment, I'm often tempted to dust off an old memo, update the details, and just insert the word "ditto." But I don't, because there's usually something worth adding.

<u>Cycles</u>

One of the most important themes in investing – and one I often find worthy of discussion – relates to cycles. What is a cycle? Dictionaries define it as "a series of events that are regularly repeated in the same order" or "any complete round or series of occurrences that repeats or is repeated." And here's the definition of the term "business cycle": "The recurring and fluctuating levels of economic activity that an economy experiences over a long period of time."

As you can see, the common thread is the concept of a series of events that is repeated. Many people think of a cycle as a continuous pattern in which a rise is followed by a fall, followed by another rise and another fall, and so forth.

These definitions are fine as far as they go, but I think they all miss something very important: the sense that each of the events in a cycle not only follows the one preceding it but is a result of the one preceding it. **I think in the economic, investment and credit arenas, a cycle is usually best viewed not merely as a progression through a standard sequence of positive and negative events, but as a chain reaction.**

Before I launch into the discussion of cycles that will follow, I want to make the point that it's hard to know where to start. It's tough to say, "The cycle started with y," since usually y was caused by x, and x by w. But we have to start someplace.

The Real Estate Cycle

I'll use the cycle in real estate as an example. In my view it's usually clear, simple and regularly recurring:

- Bad times cause the level of building activity to be low and the availability of capital for building to be constrained.
- In a while the times become less bad, and eventually even good.
- Better economic times cause the demand for premises to rise.
- With few buildings having been started during the soft period and now coming on stream, this additional demand for space causes the supply/demand picture to tighten and thus prices and rents to rise.
- This improves the economics of real estate ownership, reawakening developers' eagerness to build.
- The better times and improved economics also make lenders and investors more optimistic. Their improved state of mind causes financing to become more readily available.
- Cheaper, easier financing raises the pro forma returns on potential projects, adding to their attractiveness and increasing developers' desire to pursue them.
- Higher projected returns, more optimistic developers and more generous providers of capital combine for a ramp-up in building starts.
- The first completed projects encounter strong pent-up demand. They lease up or sell out quickly, giving their developers good returns.
- Those good returns – plus each day's increasingly positive headlines – cause additional buildings to be planned, financed and green-lighted.
- Cranes fill the sky (and additional cranes are ordered from the factory, but that's a different cycle).
- It takes years for the buildings started later to reach completion. In the interim, the first ones to open eat into the unmet demand.
- The period between the start of planning to the opening of a building is often long enough for the economy to transition from boom to bust. Projects started in good times often open in bad, meaning their space adds to vacancies, putting downward pressure on rents and sale prices. Unfilled space hangs over the market.

- Bad times cause the level of building activity to be low and the availability of capital for building to be constrained. Or, as we said in computer programming in the 1960s, “go to top” and begin again.

This process is highly illustrative of the cyclical chain reaction I’m talking about. Each step in this progression doesn’t merely follow the one that preceded it; it is caused by the one that preceded it.

Cycles and Risk

This memo is devoted to the cycle in attitudes toward risk. Economies rise and fall quite moderately (think about it: a 5% drop in GDP is considered massive). Companies see their profits fluctuate considerably more, because of their operating and financial leverage. But market gyrations make the fluctuations in company profits look mild. **Securities prices rise and fall much more than profits, introducing considerable investment risk. Why is that so? Primarily, I think, because of the dramatic ups and downs in investor psychology.**

The economic cycle is constrained in its fluctuations by the existence of long-term contracts and the fact that people will always eat, pay rent, buy gasoline, and engage in many other activities. The quantities involved will rise and fall, but not without limitation. Likewise for most companies: cost reductions can mitigate the impact of sales declines on earnings, and there’s often some base level below which sales are unlikely to go. In other words, there are limits on these cycles.

But there are no checks on the swings of investor psychology. At times investors get crazily bullish and can imagine no limits on prosperity, growth and appreciation. They assume trees will grow to the sky. Nothing’s too good to be true. And on other occasions, correspondingly, despondent investors can’t think of any limits to how bad things can get. People conclude that the “worst case” scenario they prepared for isn’t negative enough. Highly disastrous outcomes are considered plausible, even likely.

Over the years, I’ve become convinced that fluctuations in investor attitudes toward risk contribute more to major market movements than anything else. I don’t expect this to ever change.

The Source of Investment Risk

Much (perhaps most) of the risk in investing comes not from the companies, institutions or securities involved. It comes from the behavior of investors. Back in the dark ages of investing, people connected investment safety with high-quality assets and risk with low-quality assets. Bonds were assumed to be safer than stocks. Stocks of leading companies were considered safer than stocks of lesser companies. Gilt-edge or investment grade bonds were considered safe and speculative grade bonds were considered risky. I’ll never forget Moody’s definition of a B-rated bond: “fails to possess the characteristics of a desirable investment.”

All of these propositions were accepted at face value. But they often failed to hold up.

- When I joined First National City Bank in the late 1960s, the bank built its investment approach around the "Nifty Fifty." These were considered to be the fifty best and fastest growing companies in America. Most of them turned out to be great companies . . . just not great investments. In the early 1970s their p/e ratios went from 80 or 90 to 8 or 9, and investors in these top-quality companies lost roughly 90% of their money.

- Then, in 1978, I was asked to start a fund to invest in high yield bonds. They were commonly called "junk bonds," but a few investors invested nevertheless, lured by their high interest rates. Anyone who put $1 into the high yield bond index at the end of 1979 would have more than $23 today, and they were never in the red.

Let's think about that. You can invest in the best companies in America and have a bad experience, or you can invest in the worst companies in America and have a good experience. **So the lesson is clear: it's not asset quality that determines investment risk.**

The precariousness of the Nifty Fifty in 1969 – and the safety of high yield bonds in 1978 – stemmed from how they were priced. A too-high price can make something risky, whereas a too-low price can make it safe. Price isn't the only factor in play, of course. Deterioration of an asset can cause a loss, as can its failure to produce profits as expected. **But, all other things being equal, the price of an asset is the principal determinant of its riskiness.**

The bottom line on this is simple. No asset is so good that it can't be bid up to the point where it's overpriced and thus dangerous. And few assets are so bad that they can't become underpriced and thus safe (not to mention potentially lucrative).

Since participants set security prices, it's their behavior that creates most of the risk in investing. This is true in many other activities as well, the common thread being the involvement of humans.

- Jill Fredston, an expert on avalanches, has observed that "better safety gear can entice climbers to take more risk – making them in fact less safe." (*Pensions & Investments*)

- When all traffic controls were removed from the town of Drachten, Holland, traffic flow doubled and fatal accidents fell to zero, presumably because people drove more carefully. (Dylan Grice, Societe Generale)

So improvements in safety equipment can be neutralized by human behavior, and driving can become safer despite the removal of safety equipment. It all depends on how the participants behave.

<u>The Cycle in Attitudes toward Risk</u>

The riskiest thing in the investment world is the belief that there's no risk. On the other hand, a high level of risk consciousness tends to mitigate risk. I call this the perversity of risk. It's the reason for Warren Buffett's dictum that "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." When other people love investments, we should be cautious. But when others hate them, we should turn aggressive.

It is essential to observe that investor attitudes in this regard are far from constant. A memo called *The Happy Medium* (July 21, 2004) said that while it would be good for most investors (the ones not suited to be contrarians) to always hold a moderate position that balances risk aversion and risk tolerance – and thus the fear of losing money and the fear of missing opportunities – this is something very few people can do. Rather, attitudes toward risk cycle up and down, usually counter-productively. **Becoming more and less risk averse at the right time is a great way to enhance investment performance. Doing it at the wrong time – like most people do – can have a terrible effect on results.**

How does the up-cycle in risk taking develop?

- **When economic growth is slow or negative and markets are weak, most people worry about losing money and disregard the risk of missing opportunities. Only a few stout-hearted contrarians are capable of imagining that improvement is possible.**
- Then the economy shows some signs of life, and corporate earnings begin to move up rather than down.
- Sooner or later economic growth takes hold visibly and earnings show surprising gains.
- This excess of reality over expectations causes security prices to start moving up.
- Because of those gains – along with the improving economic and corporate news – **the average investor realizes that improvement is actually underway**. Confidence rises. Investors feel richer and smarter, forget their prior bad experience, and extrapolate the recent progress.
- Skepticism and caution abate; optimism and aggressiveness take their place.
- Anyone who's been sitting out the dance experiences the pain of watching from the sidelines as assets appreciate. The bystanders feel regret and are gradually sucked in.
- The longer this process goes on, the more enthusiasm for investments rises and resistance subsides. **People worry less about losing money and more about missing opportunities.**
- Risk aversion evaporates and investors behave more aggressively. People begin to have difficulty imagining how losses could ever occur.
- Financial institutions, subject to the same influences, become willing to provide increased financing. In the words of Citibank's Chuck Prince, when the music's playing, they see no choice but to dance. Thus they compete for market share by reducing the return they demand and by being willing to finance riskier deals (see *The Race to the Bottom*, February 14, 2007).
- Easier financing – along with the recent gains – encourages investors to make greater use of leverage. Borrowed capital increases their buying power, and they move to put it to work.
- Leveraged investors report the greatest gains, consistent with the old Las Vegas maxim: "the more you bet, the more you win when you win." This causes others to emulate them.
- The market takes on the appearance of a perpetual-motion machine. Appreciation accelerates, possibly leading to a mania or bubble. **Everyone concludes that things can only get better forever. They forget about the risk of losing money and fixate on not missing opportunities.** Leveraged buyers become convinced that the things they buy with borrowed money are certain to appreciate at a rate above their borrowing cost.
- Eventually things get as good as they can get, the last skeptic capitulates, and the last potential buyer buys.

That's the way the cycle of attitudes toward risk ascends. **The skeptic in times of moderation becomes a true believer at the top.**

But as Herb Stein brilliantly observed, "If something cannot go on forever, it will stop." Applying that thought here, I'd say when things are as good as they can get, they can't get any better. That suggests eventually they'll get worse.

It always turns out that – investors' hopes to the contrary – economies, profits and asset prices can't rise forever. Or, at a minimum, they can't keep pace with investors' ever-rising hopes. And thus the down-cycle begins.

- Once the last potential buyer has bought, there's nobody left to take prices higher.
- **A few unemotional, disciplined and foresighted investors conclude that things have gone too far and a correction is in the cards.**
- Economic activity and corporate earnings turn down, or they begin to fall short of people's irrationally expanded expectations.
- The error of those expectations becomes obvious, causing security prices to start declining. Perhaps someone is daring enough to point out publicly that the emperor of limitless growth has no clothes. Sometimes there's a catalyzing event. Or sometimes (see early 2000) security prices begin to fall of their own accord, simply because they had moved too high.
- The first price declines cause investors to rethink their analysis, conclusions, commitment to the market and risk tolerance. It becomes clear that appreciation will not go on *ad infinitum*. "I'd buy at any price" is replaced by "how can I know what the right price is?"
- Weak economic news takes the place of positive reports.
- **The average investor realizes that things are getting worse.**
- Interest in investing declines. Selling replaces buying.
- Investors who sat out the dance – or who just underweighted the depreciating assets – are lionized for their wisdom, and holders start to feel stupid.
- Giddy enthusiasm is replaced by sober skepticism. Risk tolerance declines and risk aversion is on the upswing. **People switch from worrying about missing opportunity to worrying about losing money.**
- Financial institutions become less willing to extend credit to investors. At the extremes, investors receive margin calls.
- Investors who borrowed to buy are heavily penalized, and the media report on leveraged entities' spectacular meltdowns. Forced selling in response to margin calls and covenant violations causes price declines to accelerate.
- Eventually we hear some familiar refrains: "I wouldn't buy at any price," "There's no negative case that can't be exceeded on the downside," and "I don't care if I ever make another penny in the market; I just don't want to lose any more."
- The last believer loses faith in the market, selling accelerates, and prices reach their nadir. **Everyone concludes that things can only get worse forever.**

<u>Coping with the Risk Cycle</u>

The important conclusions from observing the above pattern are these:

- Over time, conditions in the real world – the economy and business – cycle from better to worse and back again.

- Investor psychology responds to these ups and downs in a highly exaggerated fashion.

- When things are going well, investors swing to excessive euphoria, under the assumption that everything's good and can only get better.

- And when things are bad, they swing toward depression and panic, viewing everything negatively and assuming it can only get worse.

- When the outlook is good and their mood is ebullient, investors take security prices to levels that greatly overstate the positives, from which a correction is inevitable.

- And when the outlook is bad and they're depressed, investors reduce prices to levels that overstate the negatives, from which great gains are possible and the risk of further declines is limited.

The excessive nature of these swings in psychology – and thus security prices – dependably creates opportunities of over- and under-valuation. **In bad times securities can often be bought at prices that understate their merits. And in good times securities can be sold at prices that overstate their potential. And yet, most people are impelled to buy euphorically when the cycle drives prices up and to sell in panic when it drives prices down.**

"Buy and hold" used to be a popular approach among investors, and it performed admirably when the markets rose almost non-stop from 1960 to 1972 and from 1982 to 1999. But thanks to the lackluster results of the last thirteen years, it has nearly disappeared. Nowadays, investors are much more likely to trade in an effort to profit from – or at least avoid losses connected to – economic, corporate and market developments. However, when most investors unite behind a macro trading decision, they're usually wrong in the ways described above. This is the reason why contrarianism often pays off big.

In order to be a successful contrarian, you have to do the opposite of what the herd does. And to do that, you have to diverge from the conventional cycle in attitudes toward risk. Everyone would like to profitably resist this error-prone and thus costly cycle. The fact that most people succumb anyway shows how strong its power is, and that most people are not above average in this regard (of course). Markets move in response to decisions made by the majority of investors. Most investors are guilty of the sin of overreacting (and, even worse, the sin of moving in the wrong direction), demonstrating that the ability to resist the cycle is uncommon.

To be a successful contrarian, you have to be able to:

- see what most people are doing,
- understand what's wrong about most people's behavior,
- possess a strong sense for intrinsic value, which most people ignore at the extremes,
- resist the psychological pressures that make most people err, and thus
- buy when most people are selling and sell when most people are buying.

And one other thing: you have to be willing to look wrong for a while. If the herd is doing the wrong thing, and if you're capable of seeing that and doing the opposite, it's still highly unlikely that the wisdom of what you do will become apparent immediately. Usually the crowd's irrational euphoria will continue to take prices higher for a while – possibly a long while – or its excessive negativism will continue to take prices lower. The contrarian will appear wrong, and the fact that his error comes in acting differently from most people will make him look like nothing but an oddball loser. **Thus, in addition to the five requirements listed above, successful contrarianism requires the ability to stick with losing positions that, as David Swensen has written, "frequently appear downright imprudent in the eyes of conventional wisdom."**

If you can't stand living with the embarrassment of being unconventional and wrong, contrarianism may not be for you. Rather than trying to do the difficult opposite of what the crowd is doing, you might have to settle for merely refusing to join in its errors. That would be a very good thing. But even that is not easy.

Risk and Return Today (2004 Version)

The name of this section served as the title of a memo in October 2004. It was one of my first cautionary responses to the vertiginous market ascent that would be exposed by the sub-prime mortgage collapse in 2007 and would culminate in the global financial crisis in 2008.

In the memo I observed that the "capital market line" connecting risk and return had become "lower and flatter." The lowness meant that the line started off with low returns on low-risk assets (due to the Fed's efforts to stimulate the economy through low interest rates) and, as one moved out the risk curve, even riskier investments offered low potential returns. "Due to the low interest rates," I said, "the bar for each successively riskier investment has been set lower than at any time in my career."

The flatness of the line was a result of sanguine attitudes toward risk. Here are excerpts from my explanation (emphasis in the original):

- **First, investors have fallen over themselves in their effort to get away from low-risk, low-return investments**. **When you're especially eager not to make safe investment A, it takes less compensation than usual (in terms of prospective return) to get you to accept risky investment B**. . . .

- **Second, risky investments have been very rewarding for more than twenty years and did particularly well in 2003**. . . . **Thus investors are attracted more (or repelled less) by risky investments than perhaps might otherwise be the case and require less risk compensation to move to them.**

- **Third, investors perceive risk as being quite limited today.** Because rising inflation isn't seen as a significant risk, bond investors don't require much of a premium to extend maturity. And because the combination of a recovering economy and an accommodating capital market has brought default rates to record lows, investors are unconcerned about credit risk and thus are willing to accept below-average credit spreads. **Prospective return exists to compensate for perceived risk, and when there isn't much perceived risk, there isn't likely to be much prospective return**.

  In summary, to use the words of the "quants," risk aversion is down. . . .

> . . . **would-be buyers are optimistic, unafraid, undemanding in terms of return, and moving *en masse* to small asset classes**. Holders of assets, who play a part in setting market prices by deciding where they'll sell, also are optimistic. The result is an unappetizing, risk-tolerant, high-priced investment landscape. . . .
>
> There are times when the investing errors are of omission: the things you should have done but didn't. Today I think the errors are probably of commission: the things you shouldn't have done but did. **There are times for aggressiveness. I think this is a time for caution.**

In other words, everything seemed positive, attitudes toward risk bearing were on the upswing, and security prices moved higher, bringing down potential returns. That memo may have been too early, but it wasn't wrong. There was a fair bit of money to be made in the next few years, but its pursuit brought investors close to the peril that lay ahead.

Risk and Return Today (2013 version)

For about a year from the middle of 2011 to the middle of 2012, I was thinking and saying that given the many problems and uncertainties afflicting the investment environment, the biggest plus I could find was the near-total lack of optimism on the part of investors. And I thought it was a major plus. There's little that's as helpful for the availability of bargains as widespread low expectations.

Arguably the eight pages of this memo leading up to this point are there for the sole purpose of establishing that when investors are sanguine risk is high, and when investors are afraid risk is low. Today there's no question about it: investors are highly aware of the uncertainties attaching to the sluggish recovery, fiscal imbalance and political dysfunction in the U.S.; the same or worse in Europe; lack of growth in Japan; slowdown in China; resulting problems in the emerging markets; and geopolitical tensions. **If the global crisis was largely the product of obliviousness to risk – as I'm sure it was – it's reassuring that there is little risk obliviousness today.**

Sober attitudes on the part of investors should be a source of comfort, since in normal times we would expect them to bring down asset prices to the point where they're attractive. **The problem, however, is that while few people are thinking bullish today, many are acting bullish. Their pro-risk behavior is having its normal dangerous impact on the markets, even in the absence of pro-risk thinking. I've become increasingly conscious of this inconsistency in recent months, and I think it is <u>the most important issue</u> that today's investors have to confront.**

What's the reason for this seeming inconsistency between thoughts and actions? The answer is simple. **These people aren't buying because they want to, but because they feel they have to.** In the past I've referred to them as "handcuff volunteers."

The normal response of investors to uncertain times is to say, "Because of the risks that are present, I'm going to shy away from risky investments and stick with a very safe portfolio." Such views would tend to depress prices of risky assets. But, thanks to the actions of the world's central banks to keep rates near zero, that very safe portfolio – especially in the credit markets – will produce little if any return today.

Many investors have sought the safety of money market and T-bill funds yielding zero, Treasury notes at +/-1%, and high grade bonds at 3%. But some can't or won't. The retiree living on his savings may not be able to abide the 90% reduction in short Treasury note returns. I imagine him picking up the phone, calling the 800 number and telling his mutual fund company "get me out of that fund yielding zero and get me into one yielding 6%. I have to replace the income I used to get from intermediate Treasurys." And thus he becomes a high yield bond investor . . . whether consciously or not.

A similar process can affect a pension fund or endowment that needs a return of 7-8% and doesn't want to bet its future on the ultra-low yields on high grade bonds and Treasurys, or the 6% that the institutional consensus expects stocks to return (especially given how badly stocks performed in 2000-02 and 2008 and their overall lack of gains since 1999).

Take high yield bonds for example. They provide some of the highest contractual returns and greatest current income, they are attracting considerable capital. When capital flows into a market, the resulting buying brings down the prospective returns. And when offered returns go down, investors desirous of maintaining income turn to progressively riskier investments. In the bond world that's called "chasing yield" or "stretching for yield." **Do it if you want, but do it consciously and with full recognition of the risks involved. And even if you refuse to stretch for yield, be alert to the effect on the markets of those who do.**

Getting Rid of Money

It's relatively easy to make good investments when capital is in short supply relative to the opportunities and investors are reticent. But when there's "too much money chasing too few deals," investors compete to put it to work in ways that are injurious to everyone's financial health. I've written often about the tendency of people to accept lower returns, higher risk and weaker terms in order to deploy their capital in "hot" times (again as described in *The Race to the Bottom*). The deals they do get worse, and that makes investing riskier and less profitable for everyone.

Because the returns on "safe" investments are so low today, people are moving further out on the risk curve to pursue returns that meet their needs and are close to what they used to get. And the weight of their capital is bringing down prospective returns and making riskier deals doable.

As noted on page 9, I wrote in 2004's *Risk and Return Today* that, "The result is an unappetizing, risk-tolerant, high-priced investment landscape. . . ." At that time it happened because of excessive bullishness and a paucity of risk aversion. This time around it's occurring despite the absence of bullishness, mainly because interest rates have been rendered artificially low by the Fed and other central banks. **Regardless of the reason, things are happening again today – especially in the credit world – that are indicative of an elevated, risk-prone market:**

- Total new issue leveraged-finance volume – loans and high yield bonds – reached a new high of $812 billion in 2012, according to Standard & Poor's, surpassing by 20% the previous record set in pre-crisis 2007.

- The yields on fixed income securities have declined markedly, and in many cases they're the lowest they've ever been in our nation's history. Yield spreads, or credit risk premiums, are fair to full – meaning the relative returns on riskier securities are attractive – but the absolute returns are minimal.

I find it remarkable that the average high yield bond offers only about 6% today. Daily I see my partner Sheldon Stone selling callable bonds at prices of 110 and 115 because their yields to call or yields to worst start with numbers – "handles" – of 3 or 4 percent. The yields are down to those levels because of strong demand for short paper with prospective returns in that range. I've never seen anything like it.

- As was the case in the years leading up to the onset of the crisis, the ability to execute aggressive transactions indicates the presence of risk tolerance in the markets. Triple-C bonds can be issued readily. Companies can borrow money for the purpose of paying dividends to their shareholders. And CLOs are again being formed to buy leveraged loans with heavy leverage.

- The amount of leverage being applied in today's private equity deals also indicates a return to risk taking. As *The Wall Street Journal* reported on December 17:

> Since the beginning of 2008, private-equity firms have paid an average of 42% of the cost of large buyouts with their own money, also known as "equity," while borrowing the rest. In the past six months, the percentage has fallen to 33%, according to Thomson Reuters, close to the 31% average in 2006 and the 30% average in 2007. . . .
>
> Other measures also suggest that debt loads are hovering around pre-crisis levels. The average debt put on companies acquired in leveraged-buyout deals from July to December amounted to 5.5 times the companies' annual earnings (defined as earnings before interest, taxes, depreciation and amortization). That is higher than any two consecutive quarters since the beginning of 2008, according to S&P Capital IQ LCD. The average deal leverage was 5.4 times earnings in 2006 and 6.2 times earnings in 2007.

The good news is that today's investors are painfully aware of the many uncertainties. The bad news is that, regardless, they're being forced by the low interest rates to bear substantial risk at returns that have been bid down. **Their scramble for return has brought elements of pre-crisis behavior very much back to life.**

Please note that my comments are directed more at fixed income securities than equities. Fixed income is the subject of investors' ardor today, since it's there that investors are looking for the income they need. Equities are still being disrespected, and equity allocations reduced. Thus they are not being lifted by comparable income-driven buying.

* * *

In 2004, as cited above, I stated the following conclusion: "There are times for aggressiveness. I think this is a time for caution." Here as 2013 begins, I have only one word to add: ditto.

The greatest of all investment adages states that "what the wise man does in the beginning, the fool does in the end." The wise man invested aggressively in late 2008 and early 2009. I believe only the fool is doing so now. Today, in place of aggressiveness, the challenging search for return should incorporate goodly doses of risk control, caution, discipline and selectivity.

January 7, 2013

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Memo to: Oaktree High Yield Bond Clients

From: Howard Marks and Sheldon Stone

Re: High Yield Bonds Today

Clients often ask for our views on the high yield bond market: "Do we think prices are too high?" "Are yields too low?" "What returns can we expect next year?" We caution them that it's nearly impossible to accurately predict these things, and anyone who makes such forecasts is unlikely to be right.

These days the question is primarily whether high yield bonds are in a bubble and poised to collapse, given last year's strong performance and today's historically low yields. We don't think high yield bonds are any more vulnerable to rising rates than other fixed income instruments. We don't downplay the risk in the market nowadays and the fact that bond prices are quite high. **However, the situation isn't unique to high yield bonds; rather, it is true of virtually all bonds and reflects the concerted effort on the part of central banks around the world to hold down interest rates.** Yields are at historic lows and prices are unusually high all across the fixed income spectrum.

However, **two factors argue strongly that high yield bonds are less vulnerable to rising interest rates than other fixed income sectors**:

- A high yield bond of a given maturity has a shorter duration than an investment grade rated bond of the same maturity, since duration is a measure of the weighted average time to receipt of the promised cash flows, and the larger interest coupons on high yield bonds mean the expected payments from interest and principal are received sooner on average. Thus an increase in interest rates of a certain amount implies less of a price decline for a high yield bond than for an investment grade rated bond of the same maturity.

- In addition, rising interest rates usually imply a growing economy, and a growing economy usually means improving creditworthiness and fewer defaults.

Of course it's most unlikely that high yield bonds will deliver returns even close to 2012's performance. On the other hand, they don't have to equal last year's return to warrant holding today.

While yields are near all-time lows, yield spreads tell a very different story. Today the average spread on our U.S. high yield bond portfolios – approximately 490 basis points – is toward the high end of the normal historical range we've invested in for nearly three decades. We believe such an average spread provides more-than-adequate compensation for our default experience, which over the last 27 years has averaged 1.4% per annum. With corporate balance sheets in relatively good shape (thanks in large part to all of the refinancing activity over the past two years), the capital markets awash in liquidity, and economies (at least in the U.S.) showing some strength, default rates are projected to remain below the long-term average for at least the next twelve months.

Given their current average yield spread, we estimate that our portfolios could suffer a default rate of approximately 9% every year and still do no worse than Treasurys – and it's worth noting that we have never had even one year with a 9% default rate. So we don't think high yield bonds are overpriced in relative terms. **In fact, we feel the odds favor their delivering relative performance that is superior to Treasurys and high grade corporates over multi-year holding periods ahead.**

Finally, let's consider the potential absolute result for high yield bonds from today. Suppose we hold (or buy) high yield bonds currently at around 5.7% average yield, and we have Oaktree's average experience: an annual default rate of 1.4% and loss of about half the money invested in the defaulting bonds, or 0.7% of our portfolio per year. **This results in 5% net return per year before fees and price fluctuations. Given the alternatives today, that's an attractive absolute return. What else is better?**

If interest rates rise and/or yield spreads expand, we will suffer price declines (as will holders of all other fixed-rate securities). **But if Oaktree is right in its credit judgments, those declines will prove to be temporar**y. The bonds will be paid off at par upon maturity, and if the other assumptions above are met the 5% return will be achieved.

While we believe spreads are attractive given the risks we see in our portfolios, it is true that there is little room for price upside, making the reward for risk taking limited. (This is in essence what Howard concluded in his most recent memo, "Ditto.") **In this type of environment, superior returns are more likely to be earned through minimizing mistakes than through stretching for yield. Rather than behaving aggressively, the search for return should involve risk control, caution, discipline and selectivity.** Of course, this is what we emphasize in our portfolios.

Considering these factors, should investors sell their high yield bonds and wait for a better time to invest? We don't think so, as **market timing is next to impossible to do right and costly to attempt** in less liquid markets like high yield bonds.

February 21, 2013

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Outlook for Equities

It doesn't take much to get me started on a memo. In this case one sentence was enough, in an article from the February 4 online edition of *Pensions & Investments*, as described by *FierceFinance* on February 28: "The long-term equity risk premium is typically between 4.5% and 5%."

There's little I hate more than investment generalizations. For years, for example, self-styled authorities on the high yield bond market would say "bond defaults typically take place 2-3 years after issuance." That always set my teeth on edge. The time to default might average 2-3 years, but unless (1) that's also the most common time period (the mode) and (2) not a highly variable parameter (which I think it is), that generalization is absolutely useless.

In fact, I like the way Mark Twain summed up on the subject more than 100 years ago: "all generalizations are false, including this one." I consider most investment generalizations as useless as that great oxymoron: "common sense."

Back to equity risk premiums. The *FierceFinance* article in question led with the sentence, "The 'great rotation' back into equities from bonds is unlikely to be seen in 2013 among most defined benefit pension funds in major markets, including the U.S., U.K. and Netherlands." It included a number of what I consider provocative statements:

- that pension funds do want fewer bonds but generally not more stocks (raising the question of where the money will go, and specifically how much money can responsibly be absorbed in asset classes other than stocks and bonds),

- that, according to one consultant "There is recognition that bonds represent minimal-risk assets, so it's difficult for (plan executives) to abandon bonds in favor of equities. . ." (This overlooks the fact that there's no such thing as a minimal-risk asset regardless of price, and few assets that have been the beneficiaries of years of strong cash inflows can really be "minimal-risk"), and

- "that investors are taking short-term tactical advantage of the rising equity premium by, for example, allowing multiasset managers to drift toward the higher end of the equity allocation range."

So there we are, in the third bullet point, back to the matter of the equity risk premium.

Everything You Ever Wanted to Know About Equity Risk Premiums (and Much More)

The equity risk premium is generally defined as, "the excess return that an individual stock or the overall stock market provides over a risk-free rate." (Investopedia) Thus it is the incremental return that investors in equities receive relative to the risk-free rate as compensation for bearing the risk involved.

The term is also used to describe the extent to which the return on stocks exceeds the return on bonds, again as compensation for bearing incremental risk. (For example, an August 18, 2011 article on the *Seeking Alpha* website, entitled "What the Equity Risk Premium Is Saying," discusses the prospects for stocks versus the ten-year U.S. Treasury note.)

My real problem with the term – or, more correctly, the way it's used – has to do with one of the littlest words in the English language. Or, to paraphrase a former President of the United States, "it all depends on the meaning of the word is."

Many people know what they think they mean when they talk about the existence and magnitude of the equity risk premium – or even what they actually mean – but I don't think many are logical or consistent in using it. My complaints surround the definition they apply to the term, and specifically the tense of the verb they employ (I'm not just being grammatically picky).

Most specifically, I strongly dislike the use of the present tense, as exemplified by the writer for *P&I*: "The long-term equity risk premium <u>is typically</u> between 4.5% and 5%." This suggests that the premium is something that solidly exists in a fixed amount and can be counted on to pay off in the future.

Imagine instead that she had said "The long-term equity risk premium <u>has typically been</u> between 4.5% and 5%." This makes the premium seem more like a historical fact but also less dependable in the future (probably as it should be).

The equity risk premium can actually be defined at least four different ways, I think:

1. The historic excess of equity returns over the risk-free rate.
2. The minimum incremental return that people demanded in the past to make them shift from the risk-free asset to equities.
3. The minimum incremental return that people are demanding today to make them shift away from the risk-free asset and into equities.
4. The margin by which equity returns will exceed the risk-free rate in the future.

The four uses for the term are different and, importantly, all four are applied from time to time. And I'm sure the four uses are often confused. Clearly the import of the term is very different depending on which definition is chosen. **The one that really matters, in my opinion, is the fourth: what will be the payoff from equity investing. It's also the one about which it's least reasonable to use the word "is," as if the risk premium is a fact.**

<u>What Will Equities Give You?</u>

There are problems with at least three of the four meanings. Only **number one** can be measured. There's a lot of data on the historic performance of stocks versus bonds and cash. In fact, in the 1990s Wharton Professor Jeremy Siegel documented to a fare-thee-well that stocks always won out over long periods of time. Of course the subsequent decade proved that didn't have to remain the case.

Now it gets more interesting. Although we can calculate the amount by which stocks outperformed bonds or cash in the past (assuming you were looking at periods prior to 2000), I don't think that's the same as saying what risk premium was demanded by investors in the sense of **definition number two** above. If stocks outperformed by 5% over a ten-year period, that doesn't mean people demanded a 5% higher return to buy equities rather than bonds or the risk-free asset. They might have "demanded" more or less. It's just that they got 5%.

In a similar vein, we can also talk about **number three**, the minimum return increment people are demanding today. But (a) the answer you come up with will depend on whom you ask, (b) they may or may not have given it rigorous thought, and (c) whatever they say is likely to have little impact on what relative returns turn out to be. Their answer is likely to tell you more about what they think they'll get than about what they're actually demanding . . . or what they will get.

What matters for today's investor isn't what stocks returned in the past, or what equity investors demanded in the past or think they're demanding today. What matters is **definition number four**, what relative performance will be in the future. **The most important thing of all is to realize that this can't be read anyplace.** As Einstein said, in one of my favorite quotes, "Not everything that counts can be counted, and not everything that can be counted counts."

Just as number four is the most important definition of the equity risk premium, the questions surrounding it are also significant. In my view, people tend to think of the equity risk premium (and other risk premiums) like credit spreads on bonds. I've been dealing with credit spreads for 35 years. They are the entire *raison d'être* for high yield bond investing. **And they have almost nothing in common with the equity risk premium.**

Let's say we want to assess the adequacy of the reward being offered for bearing the credit risk of a given B-rated high yield bond. We compute the yield to maturity or yield to call on the bond and subtract from it the yield to maturity on a Treasury security of the same duration. The result is the "yield spread" or "credit spread." That spread tells us what the prospective relative return is and – when assessed in the light of historic spreads, the spreads on other bonds, the riskiness of the bond in question, and the spreads on other bonds of similar, lesser or greater riskiness – whether the bond is rich or cheap.

Now let's apply the same process to a stock, or the stock market. First, compute the prospective return on the stock. Oh yeah; right. There's no way to do that. Or rather there is, but it requires one to either (a) make an assumption about the growth rate of earnings per share to infinity or (b) make an assumption about the growth rate of earnings for a number of years and also the terminal p/e ratio that the market will apply to e.p.s. at the end of that period (which in turn will be a function of the growth of earnings from then to infinity). **In other words, a simple mathematical calculation will tell us exactly what the promised return on a bond is (albeit not the probability that it will be received), while coming up with the future return for a stock requires making some massive guesses about the far-off future. That difference – in a nutshell – encapsulates a lot of the fundamental difference between investing in stocks and bonds.**

The bottom line: given that it's impossible to say with any accuracy what return a stock or the stock market will deliver, it's equally impossible to say what the prospective equity risk premium is. **The historic excess of stock returns over the risk-free rate may tell you the answer according to definition number one, with relevance depending on which period you choose, but it doesn't say anything about the other three . . . and especially not number four: the margin by which equity returns will exceed the risk-free rate in the future.**

<u>Another Call for Counter-Intuitiveness</u>

Many of the important things about investing are counterintuitive. Low-quality assets can be safer than high-quality assets. Things get riskier as they become more highly respected (and thus appreciate). There can be more risk in thinking you know something than in accepting that you don't. This counter-intuitiveness is a favorite theme of mine.

And the theme is importantly at work with regard to the equity risk premium, and especially *P&I*'s use of the term. I take great issue with their statement "The long-term equity risk premium is typically between 4.5% and 5%." **That may be what it "was" or "has been," but it doesn't tell us anything about what it "is" or "will be."** We know we can't extrapolate returns on bonds or the risk-free asset from the past; certainly changes in interest rates over the last five years mean investors in these things will enjoy far lower returns in the years ahead than they used to. **So then is it possible to know what we will get from equities? Or from equities relative to bonds or the risk-free rate? Clearly not. Thus I think it's dangerously misleading to say what the risk premium "is."** That's probably enough on this subject.

Let's move on to the final bullet point on page one and its reference to "the rising equity premium." The article discusses the case for an attractive equity risk premium in terms of definition number one – historically superior performance – since it goes on to point out that stocks outperformed bonds by an unusually large margin in the six months ended January 31, 2013 (11.23% for the Russell 3000 versus -0.29% for the Barclays Capital U.S. Aggregate Bond Index). But do six months of good performance say anything about a rising equity premium? And do they tell us anything at all about the future?

Well, the answer to the first question lies in which definition you're following. Of course the data tells us what the relative performance was (and 2012 was a great year, for example, with the S&P 500 up roughly 16% while the risk-less rate was close to zero). An equity risk premium defined this way is certainly in the best part of the historic distribution. But it tells us little about investors' past or present demanded returns. And what does it say about the prospects for continued outperformance?

To me, the answer is simple: the better returns have been, the less likely they are – all other things being equal – to be good in the future. Generally speaking, I view an asset as having a certain quantum of return potential over its lifetime. The foundation for its return comes from its ability to produce cash flow. To that base number we should add further return potential if the asset is undervalued and thus can be expected to appreciate to fair value, and we should reduce our view of its return potential if it is overvalued and thus can be expected to decline to fair value.

So – again all other things being equal – when the yearly return on an asset exceeds the rate at which it produces cash flow (or at which the cash flow grows), the excess of the appreciation over that associated with its cash flow should be viewed as either reducing the amount of its undervaluation (and thus reducing the expectable appreciation) or increasing its overvaluation (and thus increasing the price decline which is likely). The simplest example is a 5% bond. Let's say a 5% bond at a given price below par has a 7% expected return (or yield to maturity) over its remaining life. If the bond returns 15% in the next twelve months, the expected return over its then-remaining life will be less than 7%. An above-trend year has borrowed from the remaining potential. The math is simplest with bonds (as always), but the principle is the same if you own stocks, companies or income-producing real estate.

In other words, appreciation at a rate in excess of the cash flow growth accelerates into the present some appreciation that otherwise might have happened in the future. Or to paraphrase Warren Buffett, "when people forget that corporate profits are unlikely to grow faster than 6% per year, they tend to get into trouble." I doubt he intended anything special about 6%, but rather a reminder that when assets appreciate faster than the rate at which their value grows, it isn't just a windfall but also a warning sign.

Let's take a look at the 1990s, a decade full of lessons about equities. As of 1990, the historic return on equities stood at 9% or 10%, and for that reason attitudes toward them were generally favorable, with that 9-10% return expected to repeat in future decades. But the '90s were a salutary period in terms of economic growth, corporate performance, technological and productivity gains, declining interest rates, low inflation and relative peace in the world (as well as naïve optimism regarding the benefits of a credit-fueled expansion, the profit potential of e-commerce companies, and the extent to which equity gains could be perpetuated). As a result, equity returns averaged 20% per year over the decade.

What was investors' response? They ratcheted up their expectations. I believe by 2000 the professional consensus for future equity returns had risen from the 9-10% range to 11%. A decade of the highest returns in history had convinced people that more good years lay ahead. Few people seemed concerned that the extraordinary returns of the 1990s might have borrowed from the 2000s (as certainly seems to have been the case in retrospect). As a result, just when stock prices were reaching levels they wouldn't see again for more than a decade, bonds were being dumped so that equity allocations could be expanded to all-time highs.

When I look at the *P&I* article, I see a statement that the equity risk premium is on the rise, but not a lot of reason why equities will do better in the future than they have in the past (or even specific mention of which past they'll do better than). **Extrapolation or analysis? They're two very different things.**

<ins>Valuing Stocks Today</ins>

The underlying reason it took so little from *FierceFinance* to get me going on this memo is that I had a lot of pent-up thoughts about equities and their current valuation. That's what the following pages will be spent on.

Ironically given the extent to which I railed above about limiting the importance attached to the equity risk premium, some of the strongest arguments for stocks today surround their relative earning power. In view of the difficulty in quantifying the prospective returns on stocks, appraising their value relative to bonds or the risk-free asset is often best done through comparing their yields.

Since most companies pay out a modest percentage of their earnings, dividend yields greatly understate companies' ability to earn money for their shareholders, and thus for their stocks to appreciate. A better measure of stocks' long-term potential may be found in their "earnings yield." The earnings yield is the reciprocal of the p/e ratio: the e/p ratio or ratio of earnings to price. To gauge relative price-attractiveness, it isn't unreasonable to compare the earnings yield on a stock against the yield on a bond (or against the risk-free rate).

Let's review a few data points:

- If the post-WWII average p/e ratio on equities was something like 16 (for an e/p ratio of 1/16, or an earnings yield of about 6.25%) and if I guess at a "normal" risk-free rate of 3%, we get a historic yield differential – we might call it the equity risk premium, defined this way – of 3.25% (6.25% minus 3.00%), or 325 basis points. The ratio between the yields was 6.25%/3.00%, or 2.08x.

- At the high in 2000, the p/e ratio on the S&P 500 was more like 32 (for an e/p ratio of 1/32, or an earnings yield of 3.12%), and the 30-day T-bill rate was probably 2%. In that case the yield differential or equity risk premium was a skimpy 1.12% (3.12% minus 2.00%), or 112 basis points, and the ratio of the two was only 3.12%/2.00%, or 1.56x. In other words, stocks didn't offer enough relative to fixed income, and that's the main reason why they've performed so poorly – both in absolute terms and relative to bonds – over the thirteen years since.

- Where are we today? The p/e ratio on the S&P 500 is back to about 16, meaning the earnings yield is 6.25% once again. I'll use a 30-day T-bill rate of 1.00% (it's actually closer to zero, but a yield ratio approaching infinity wouldn't be meaningful). That gives us a yield differential of 5.25% (6.25% minus 1.00%), or 525 basis points, and a yield ratio of 6.25%/1.00%, or 6.25x.

So let's recap:

	Post-WWII Norm	2000	Today
Yield differential	325 b.p.	112 b.p.	525 b.p.
Yield Ratio	2.08x	1.56x	6.25x

Certainly the yield comparison is highly favorable for stocks today. In fact it's one of the best in the last century (probably barring only the early 1980s, when the p/e ratio on the S&P 500 fell to mid-single digits). Is that the whole story? It never is; nothing's that simple, especially in the world of investing.

The problem with basing a pro-equities argument on the yield comparison is that most of equities' current attraction on that basis comes from the lowness of interest rates. Just about everyone knows (a) interest rates are artificially low because of central banks' efforts at stimulus and (b) rates will be considerably higher at some point in the intermediate term. In that case, rising rates would render stocks less attractive (all other things being equal, but they're not – see below).

<u>The Other Pros and Cons of Equities</u>

There are many ways to view valuation, and many elements in the current debate over equities. Here are a few of them (I'll start by reiterating the above for the sake of completeness):

- The differential between the S&P earnings yield and the risk-free rate or the yields on bonds – and their ratio – makes stocks look extremely cheap. PRO

- The attractiveness of these relative valuation parameters is highly dependent on interest rates staying low. CON (or LESS PRO)

- Relative to normal post-WWII p/e ratios, stock prices are average to slightly low as a multiple of projected earnings for the year ahead. PRO

- Robert Schiller's cycle-adjusted p/e ratios are gaining increased attention, and they suggest full rather than fair valuations. CON

- Arguably earnings growth in the years ahead will be slower than that which prevailed in the decades following WWII. Thus the post-war valuation norms are too high under the changed circumstances and should be discounted. CON

- The outlook for earnings is restrained by the questionable macro environment, including the challenges in restarting growth and the dire prognosis for the federal deficit. These problems may not be easily solved. CON

- Among the things keeping earnings high – and thus making stocks seem attractive – are some of the highest profit margins in history. If profit margins were to move toward normal levels, this would bring down earnings, either taking stock prices down with them or lifting p/e ratios and thus reducing stocks' attractiveness. CON

- Corporate cash hoards are high, implying some combination of safety, potential for stock buybacks, and possible dividend increases. These are all good for shareholders. PRO

- Investor attitudes toward stocks remain tepid (see below). PRO

- However, with the S&P 500 up 16% last year and 10% so far this year, it can't be argued that stocks have been overlooked and or that attitudes towards them are still mired in the doldrums. CON

<u>The Role of Investor Attitudes</u>

I covered this subject at length in "Déjà Vu All Over Again" (March 19, 2012). I'm not going to drag you through it again, but I will copy over parts of that memo from a year ago:

> . . . 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. . . . Stocks have gone through a decade in which their absolute return was negligible and their real return was negative. . . . They face a litany of negatives, without any real possibility of relief . . .
>
> 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. . . .

The thing to notice about the preceding paragraphs is that when I wrote them a year ago, I didn't do so to describe then-current market conditions. Rather, I was trying to capture conditions as they were in 1982, when *BusinessWeek* magazine carried a cover story trumpeting "The Death of Equities." My point was that in 1982, overly negative investors were fixated on the reasons for continued lethargy on the part of stocks, just when the scene was set for the greatest upsurge in stock market history.

> . . . 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.**

I didn't think last year that the extent of the undervaluation was anywhere as great as it had been in 1982, but I did think the conditions were similar in kind. Nothing sets the stage for an upturn as well as excessive negativism – or at minimum excessive disinterest. And that's what I sensed in the stock market last year, following on the heels of a twelve-year malaise. Thus I don't consider it a freak occurrence that stocks all around the world went on to have an excellent year in 2012.

Many conditions remain similar . . . again, in kind. Equity mutual funds are seeing only modest inflows, albeit the outflows have stopped. Even though they've appreciated, stocks still aren't highly valued. Many institutions have allocations to equities that are well below the average of the last fifty years, and no one's rushing to move them up. In other words, I'm comfortable saying attitudes toward equities are characterized by relative disinterest and apathy.

This is certainly something that can turn. If it turns, it can have a significant impact. And what is most likely to turn it? It won't necessarily take a "grand bargain" in Washington to solve the nation's fiscal problems, or a sudden rebirth of economic growth worldwide, or the invention of the next iPhone. All that's required is another good year or two for stocks and a switch in investor psychology from "stocks are unlikely to do anything but extend the 'lost decade' " to "hey, I'm afraid I might not be positioned adequately to participate in the next bull market."

A move upward can be powered by a switch from the fear of losing money to the fear of missing opportunity. When attitudes are moderate and allocations are low, it doesn't take much.

* * *

In the mid-1970s I was fortunate to happen upon one of the first of the time-worn pearls of wisdom that contributed so much to my education as an investor. It described the three stages of a bull market:

- the first, when a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone's sure things will get better forever.

In "The Tide Goes Out," written in March 2008, several months before the lows of the financial crisis, I applied the same thinking to the converse – the three stages of a bear market:

- the first, when just a few prudent investors recognize that, despite the prevailing bullishness, things won't always be rosy,
- the second, when most investors recognize things are deteriorating, and
- the third, when everyone's convinced things can only get worse.

Hindsight always makes it clear what was going on at a particular point in time. It's a snap now to say the second quarter of 2007 marked the third stage of a bull market: no one could think of a way to lose money. And in the fourth quarter of 2008 (for credit) and the first quarter of 2009 (for equities), we were certainly in the third stage of a bear market: most people thought the financial system was about to collapse, and securities that had halved in price could do nothing but halve again.

But the study of market history only makes us better investors if it teaches us how to assess conditions as they are, rather than in retrospect. When I wrote "Déjà Vu All Over Again" a year ago, it was my feeling that equities were in the first stage of a bull market. Experience had been so bad for so long – and the level of disinterest was so high – that only a few investors thought equities could ever catch on again. Those low expectations, when combined with modest fundamental and psychological improvement, gave the S&P 500 a return of about 13% over the year since that memo was written.

So now we have a somewhat improved fundamental environment, a generally more optimistic group of investors, and stock prices that are a fair bit higher. **No one should say the likelihood of improvement is entirely unrecognized today, as would have to be the case for this to still be stage one. I think the existence of improvement is generally accepted, but that acceptance is neither extremely widespread nor terribly overdone. Thus I'd say we're somewhere in the first half of stage two. Pessimists no longer control market prices, but certainly neither have carefree optimists taken over.**

* * *

A great rotation? Maybe . . . or maybe not. Nowadays pundits and the media are quick to come up with cute labels – usually just the right size for a headline or sound bite – to describe things that are taking place or that "everyone knows" are just around the corner. **I don't know whether it's going to be great. Heck, I don't even know if it'll happen.** But I like to enumerate the pros and cons and try to put them in perspective, as much as I like skewering excessive generalizations and pat pronouncements.

Of course, doing that isn't enough. I feel I should come down on one side or the other. **Thus I'm quite comfortable imagining a few years of equity performance that provide a pleasant surprise relative to what I think is the prevailing expectation of 6% or so per year.**

And if I'm wrong – if there is no rotation from fixed income to stocks – I'm not that worried that I'll end up with great regret over having failed to pile into T-bills yielding zero or the 10-year note guaranteeing 2.0%. When attitudes are moderate and allocations are low, like I feel is currently the case with equities, there's little likelihood of investing being a big mistake. And when interest rates are among the lowest in history, it would take deflation, depression or calamity to make failing to invest in Treasurys and high grade bonds a serious omission.

March 13, 2013

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Role of Confidence

Confidence is generally defined as <u>belief</u> in one's ability to choose a course of action and execute on it. Although it's not part of the definitions I've consulted, I think confidence also connotes <u>optimism</u> (at least it does among investors). Finally, there's an element of <u>certainty</u>: beyond an optimistic view of the future, there's conviction that view is correct. **Taken together, the ingredients I see in confidence – belief, optimism and certainty – combine to create a feeling of well-being. Confident investors are sure big returns lie ahead.**

<u>The Confidence Effect</u>

The so-called "wealth effect" plays an important and well recognized part in the functioning of an economy. In short, when assets appreciate in value, the owners of those assets translate their increased wealth into increased spending. While at first glance this is unsurprising, it should be noted that this is true even if the appreciation is unrealized, and thus the increased wealth exists solely on paper. The relationship can be simply stated as follows: the richer people feel, the more they spend.

Changes in confidence have an impact on behavior similar to the wealth effect. That's what this memo is about.

I have long been impressed by the role of confidence in an economy. In fact, I've written in the past – exaggerating only slightly – that sometimes I think confidence is all that matters. I consider its impact to be significant, pervasive, self-reinforcing and self-fulfilling.

The primary impact of confidence on the economy is simple. **If people think the economic future will be good, they'll spend and invest . . . thus things will be good.**

- Consumers' optimism will translate into incremental demand for goods, adding to GDP.
- Consumer buying will convince businesses to invest in expanded facilities and additional workers in order to keep up with growing demand.
- Businesses' investment in plant and workers will add to GDP.
- Newly hired workers will have money to spend, and their buying will add further to the cycle.
- The reports of confidence-fueled increases in GDP and other positive mentions of the economy in the media will reinforce this virtuous circle of optimism: back to step one.

So, just like the wealth effect, increased confidence makes people and businesses spend more, and this in turn cycles back into the economy. **Confidence leads to spending; spending**

strengthens the economy; and economic strength buttresses confidence. It's a circular, self-fulfilling prophesy.

Confidence can also fuel market movements. Belief that the price of an asset will rise causes people to buy the asset . . . making its price rise. This is another way in which confidence is self-fulfilling.

Of course, the confidence that underlies economic gains and price increases only has an impact as long as it exists. Once it dies, its effect turns out to be far from permanent. As the economist Herb Stein said, "If something cannot go on forever, it will stop." This is certainly true for confidence and its influence.

Confidence Today

Back in September, I wrote a memo entitled "On Uncertain Ground." It began as follows: "The world seems more uncertain today than at any other time in my life." I went on to review the many elements contributing to uncertainty. For the sake of completeness, I'm going to restate and update my list. These are things I'm asked about all the time. I don't recall another time when the list was as long:

In the U.S.:

- Will the recovery from the recession of 2008 – long in the tooth but still halting and unsteady – ever gain vitality? Today it seems we're experiencing "two steps forward, one step back," as positive reports are regularly mixed with disappointments. Further, even the improvements – in areas like job creation, consumer confidence and manufacturing output – seem tepid rather than eye-popping. This is quite different from the recoveries of the last few decades.
- To what extent will the recovery be impaired by recent tax increases and the budget cuts mandated by "sequestration"?
- When will sales increases overcome businesses' resistance to spending on plant and personnel?
- How much longer will the Fed keep interest rates low? Three months? Three years? In perpetuity?
- What will happen when it no longer does? Will rates rise? How much? Will the effect of higher rates on the cost of financing purchases and investments be enough to slow the economy? And what will be the impact of higher rates on the government's cost of financing, and thus on the deficit?
- What are the implications of the fact that the Fed's balance sheet has swelled to over $3 trillion? How does the Fed pay for the bonds it buys under QE? Will it have to pay that money back? Will the Treasury have to pay off the Fed when the debt matures? Where will it get the money? And where will the money go? (Think about this for a minute: do you feel you understand the workings of this process? Do you know anyone who does?)
- Will our economy ever get back to the higher growth rates of the late twentieth century, or will we be stuck in a slow-growth mode?

- Will "structural unemployment" in the future remain stubbornly above the 5% or so of the last few decades?
- Will profit margins retreat from their current record levels, and if so, what will be the effect on corporate profits?
- Longer term, can progress ever be made on cutting the budget deficit and reducing the unfunded entitlement obligations?
- What will be the social ramifications of slow growth, high unemployment and increased income disparity?
- Will the U.S. devalue the dollar, the usual path to dealing with excessive national debt?
- Will slow growth lead to Japan-style deflation? Or will high-volume money printing to make it easier to repay the debt bring on chronic inflation? (The mere fact that intelligent people worry simultaneously about both these polar opposites is in itself an indicator of the high level of uncertainty that is present.)

In Europe:

- Can the seeming downward spiral in peripheral Europe's economies be arrested?
- Can Europe's excessive indebtedness be brought down, and can the chronic deficits that led to that level of indebtedness be trimmed through austerity?
- Will richer nations continue to support poorer without insisting on the latter applying painful austerity?
- In practical terms, can austerity be undertaken at a time of economic weakness? If austerity is continued, are recession, suffering and unrest unavoidable?
- Won't voters demand isolationism in the richer nations and relief from the pain of austerity in the poorer nations? Won't elected leaders offering anything else be ousted?
- Will the highly restrictive regulations and labor laws be eased so as to enable Europe to compete on an equal footing with the rest of the world?
- Longer term, will the nations of Europe give a central body the control over economies and financial institutions required for an effective economic union?
- Will UK voters vote in the coming referendum to stay in the European Union or leave?
- Will the EU remain intact? Is a political union in which actions require unanimous support practical? Can governance and coordination be improved?

Regarding Leadership:

- Are there leaders – anywhere in the world – of the caliber we need to see us through these uncertain times?
- Can officials who seek re-election first and foremost rise to the occasion and make the tough decisions needed to apply unpopular solutions to problems, rather than palliative Band-Aids?
- Will the successors to Geithner and Bernanke prove up to the task of continuing the recovery while weaning the economy from ultra-low interest rates?
- Is it conceivable that America's elected leaders will create an environment in which uncertainty over taxation, regulation and healthcare costs no longer discourages businesses from investing in plant and personnel?

Miscellany:

- Will China's credit-abetted economy experience a hard landing or a soft one?
- If China's growth slows, what will be the effect on nations such as Brazil, Australia and Canada that have prospered by supplying it with commodities? What will happen to commodity prices?
- Will Prime Minister Abe's monetary and fiscal program be enough to wake Japan's economy from its lethargy?
- Will fracking allow the U.S. to achieve energy self-sufficiency? If so, what will that do to its manufacturing competitiveness and to the price of oil?
- What will happen in hot spots such as the Middle East, Iran and North Korea?

Significant uncertainty is one of the outstanding characteristics of today's investing environment. It discourages optimism regarding the future and limits investors' certainty that the future is knowable and controllable. In other words, it saps confidence. **This is a major difference from conditions in the pre-crisis years.**

<u>Confidence in 2007</u>

When I think about how the investment environment of today differs from earlier times, the greatest change of all jumps out at me. Let's go back to just before the onset of the sub-prime crisis in mid-2007. I think in those days most people were 100% certain they knew:

- what made the global economy tick,
- what the economic and business world would look like in five or ten years, and
- what it would take to fix something that went wrong.

Belief in the things listed above largely eliminated uncertainty regarding the future and contributed to an extremely high level of confidence. No one thinks that way today.

<u>Confidence: Good or Bad?</u>

Let's say I have accurately described that confidence, optimism and certainty were high in 2007 and low in 2013. **Here's a key question that I've been wrestling with: which is more desirable?**

The answer is largely a function of your timeframe. The high level of confidence in 2007 – not unlike that of the 1990s – contributed to a feeling of great well-being. **The feeling that nothing would go wrong – that a perpetual-motion machine could be counted on to keep things on an upward course forever – contributed to rampant consumer optimism, aggressive spending, rising economic aggregates, accommodative capital markets and strong asset prices.** It sure felt good.

But was it desirable? It was not, in my view, because hindsight shows perception to have been very much out of proportion with reality, and thus dangerous:

- Consumer confidence, and thus spending, was too high relative to incomes.
- Excessive spending – all around the world, at all economic levels – led to excessive use of credit, making the world highly overleveraged.
- Buying fueled by confidence and leverage caused asset prices to rise out of proportion to value.

I often say the riskiest thing in the world is widespread belief that there's no risk. And certainly that was the prevailing condition in the pre-crisis years of 2005-07, as well as during the tech bubble of the late 1990s. In both instances the "era of well-being" was followed by a significant economic slowdown and market decline.

A feel-good environment characterized by strong confidence creates pleasant current conditions but encourages dangerous behavior and an ascent (in the economy and the markets) from which a correction becomes inevitable. In that way, the less confident attitudes of 2013 create a lackluster, less enjoyable environment, but also a preferable and more prudent base for the future. (The wild card, as described in "Ditto," January 7, 2013, is that the actions of central banks to lower interest rates have caused even unconfident investors to engage in pro-risk behavior, setting the stage for the market declines of June and perhaps for additional pain in the future.)

I've previously told the story of having been in New York on 9/11, and of requiring several days to get back to Los Angeles. When I eventually reached home, my son Andrew asked me, "Dad, is the world less safe than it used to be?" My answer was, "Maybe it's less safe than it used to be, or maybe it was never as safe as everyone thought it was." **Certainly it's healthier to recognize and accept uncertainty than to act as if the world is a safe place if it's not. That goes double for the world of investing.**

<u>The Pendulum in Confidence</u>

I probably write more about the pendulum of investor psychology than I do anything else. It was the subject of my second memo, in 1991, and my belief in its impact has grown unabated ever since.

The pendulum swings with regard to many facets of the market, and it often swings to extremes:

- between optimism and pessimism,
- between greed and fear,
- between euphoria and depression,
- between credulousness and skepticism,
- between risk tolerance and risk aversion, and thus
- between reckless aggressiveness and excessive caution.

While the pendulum moves with regard to all these things, the swinging movement, the extent and the error all reflect common themes. They're all examples of the ways in which, as Mark Twain said, history rhymes.

Let's take for an example one regard in which the pendulum swings: investor attitudes toward emerging markets. Sometimes they're considered scary and exotic places, and sometimes they're the attractive high-growth alternative to the stagnant developed world. When people have confidence in the emerging markets and see only their virtues, the stocks sell at U.S.-style p/e ratios (where they're described as being cheap given the superior growth rates). But when problems emerge and confidence falters, investors will only buy emerging market stocks at discount p/e's so as to have the benefit of the risk premiums they consider necessary. I've seen this swing – just like the others – numerous times.

I'm thinking back to 1994, when NAFTA was enacted, easing trade in North America. People were in awe of Mexico: "It's just like the U.S., but it grows much faster." So money flowed to Mexican stocks, and they boomed. But then, in short order, there occurred a revolt in the state of Chiapas, the assassination of a presidential candidate, and the devaluation of the Mexican peso, triggering the so-called "Tequila Crisis." And the pendulum swung back toward concern: "Oh, right – there are differences."

And just a few years ago, the consensus of investors held that it was all over for the developed world, and China was the only economy with potential thanks to its growing population, low labor costs and expanding consumer class. As a result there was too much confidence in China and too little in the rest of the world. China does have many advantages, and the problems of the developed world aren't imaginary. But that doesn't mean Chinese equities are worth the moon and developed world equities are without value. So after Chinese stocks did much better than developed world stocks in 2009, they were primed for subsequent underperformance.

Now with China reporting slower growth – and with the threat of reduced bond buying by the Fed eating into expectations for growth worldwide (and, with it, demand for China's exports) – confidence in China has receded. As a hedge fund strategist said in *The Wall Street Journal* on July 15, "It's not all sunshine in emerging markets anymore."

Summing up, I think it's fair to say one of the key swings of the investment pendulum is between too much confidence and too little.

- At the positive extreme, people believe only good outcomes are possible, and that they (or their managers) are competent to fashion portfolios that will expose them to all of the market's gains and few of its losses, to pick the winners and avoid the losers, and to ride the market's rise and get out just as it crests.

- And at the negative extreme, they conclude only bad outcomes are possible, and that any efforts to add value or cope with the market's vicissitudes on their part or the part of their now-defrocked managers will be utterly unavailing.

As we've seen endless times, investors reach the overconfident state when things have been going well for a while, meaning prices have already soared. And, alternatively, the latter hopeless state is inevitably reached after a bubble has been punctured, the news has turned unremittingly negative, and prices have collapsed.

This is the pattern that makes the herd wrong at the extremes and creates the rewards for contrarianism. And it's behind my favorite Warren Buffett quote: "the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." **When most investors are driven to drop their prudence by an excess of confidence, we should be terrified. In the same way, when most investors become devoid of confidence and flee the market, we should turn aggressive.**

<u>All Good or All Bad?</u>

One of the things worth noting about the swing in confidence is not merely that it rises and falls, but that it is often marked by "all-good" or "all-bad" thinking. In short, when investors are optimistic regarding the future:

- They tend to see the positives, by which they're incredibly impressed, and overlook the negatives.
- If they consider negatives at all, they fall for rationalizations that refute them. Foremost here is the old standby: "It's different this time."
- Isolated positive developments, often random or fortuitous, are generalized into an irresistible virtuous circle. Coincidences are accepted as part of a bullet-proof cause-and-effect process.

This unobjective process eliminates balanced analysis and leads to dangerously unwarranted levels of confidence, and thus of investment risk.

The years leading up to the financial crisis of 2008 were marked by the most extreme all-good thinking I've ever seen. In fact, when *The New York Times* asked me to write an article on the cause of the crisis, the one I wrote was titled "Too Much Trust; Too Little Worry." I said an excessive level of confidence had caused investors in 2005-07 to:

- stop applying skepticism,
- stop worrying about losing money,
- stop doing thorough due diligence,
- stop factoring in conservative assumptions,
- stop applying risk aversion,
- stop denying capital to risky schemes, and
- stop demanding adequate risk premiums.

In mid-2007 I was working on a memo with the projected title "The Mother of All Cycles." But I got worried about how people would react to my borrowing a phrase from Saddam Hussein, so when it was published on July 16, I changed the title to "It's All Good." In the memo I complained that every asset class, every asset and every region was appreciating.

> In terms of amplitude, breadth and potential ramifications, I consider it the strongest, most heated upswing I've witnessed. A lot of this is because people seem to think everything's good and likely to stay that way.

As I saw it, overconfident investors were ignoring the possibility of things going down as well as up, swallowing promises of limitless potential, suspending disbelief, accepting financial innovation as sure to work, and embracing the trend toward increased leverage.

Of course, this house of cards fell apart in short order. Thus that memo was followed by "It's All Good . . . Really?" two weeks later, on July 30, and then by "Now It's All Bad?" on September 10. In just eight weeks, confidence had evaporated and been replaced by widespread pessimism. And just a year after that, we witnessed the bankruptcy of Lehman Brothers and the onset of the worst financial crisis in 80 years.

What this reminds us is how dangerous the world can be when confidence is too high and people are too comfortable. Also, the speed with which things can reverse demonstrates, as my partner Sheldon Stone says, that the air goes out of the balloon much faster than it goes in. It usually takes years for confidence to reach a dangerous zenith, but then only weeks or months for it to collapse.

"Everything that was good for the market yesterday is no good for it today."

When people conclude that all the merit is on either the positive or negative side of the argument, they reach extreme conviction regarding their view of the future and become certain they know what to do. But all-good or all-bad attitudes are rarely right, since there are invariably valid points on both sides and they mustn't be ignored. Mark Twain said, "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." **Most of the time, limits on confidence are more desirable than cocksureness. Over-confidence in one's judgment is very dangerous.**

The Bull/Bear Cycle

In March 2008, in "The Tide Goes Out," I repeated one of the most helpful of all the adages to which I hold – the description of the three stages of a bull market:

- the first stage, when a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone's sure things will get better forever.

What does it really mean? **The essential raw material for a bull market is cheapness, and that cheapness exists in stage one precisely because there are so few believers and so little confidence that favorable developments and good times lie ahead.** Thus stage one provides the launching pad for a bull market.

Equally, in the third stage the bull market is primed to end – with the bubble popping and a down-cycle setting in – for the simple reason that there are too many believers (and too few skeptics). **In short, there's too much confidence and too little cheapness. It's this imbalance that creates market tops.** The extremeness of the bull-market upswing – just like the downswing of its bear-market counterpart – gives investors what should be an important signal.

The Sure Thing

Investors may profess confidence in their ability to grapple with the future, but deep down many sense their own limitations and feel at sea. Thus they're prime targets for the newly minted "silver bullet" that's touted as sure to deliver return without commensurate risk. They develop outsized confidence in it, especially if at first it provides the hoped-for results. The most attractive of these are often mechanical, since their perfection stems from a dependable machine rather than a mysterious swami.

- In 1987, investors fell for "portfolio insurance," under which they could take on disproportionately large equity allocations, secure in the knowledge that if the market started down, the technique would automatically enter sell orders. But when the Dow Jones Industrial Average fell 22.6% on Black Monday (October 19), many brokerage firms refused to answer their phones, the sell orders weren't executed, and the "sure thing" turned out not to be.

- In the early 2000s, "portable alpha" promised high returns by overlaying hedge funds with equity futures. But when stocks fell, it became clear that the previous high returns had come not from the value added by a dependable process, but from the fact that in essence the futures had allowed people to be more than 100% invested in a rising market.

- And more recently, "risk parity investing" worked through volatile times because it gave its followers greater strategic diversification, defensiveness and bond exposure than most other investors had. But it, like most other things, failed to prevent losses when Ben Bernanke spooked the market by threatening to ease off bond buying and let interest rates rise. This year's results for risk parity show that nothing works all the time.

The point is that no mechanical tools can enable investors to prosper under all circumstances. They can provide tilts or reduce exposures, but the tool that promises a mix of good results and great results without the possibility of bad results is too good to be true. And when excessive confidence develops in such things, investors are heading for trouble.

The same is true for the Greenspan put and its successor, the Bernanke put. Alan Greenspan's tenure as Fed chairman was marked by efforts to avoid problems by injecting liquidity and lowering interest rates. Investors put great stock in his ability to keep things moving ever upward. His policies prevented occasional corrections along the way, but the price paid was a big one: the financial crisis of 2008. Those who had believed in Greenspan's omnipotence were unprepared for the consequences. Ben Bernanke succeeded Greenspan, and his own successor is likely to be announced soon. We must beware of equally excessive confidence in any individual's abilities.

There is no magic solution. Nothing and no one can render economies, markets or portfolio results capable of rising but never falling. Awareness of that is wise. Belief to the contrary is dangerous.

*   *   *

As mentioned above, I think recently many investors have been holding riskier positions than are natural for them, largely because, thanks to the Fed's low-rate policies, the lower-risk things they might have preferred offered so little return. Thus their investing actions were coerced, rather than being undergirded by confidence in the fundamentals.

The uncertainty that has been present in the last few years should have had a healthy effect on the environment by calling for a high level of prudence . . . if the Fed had let it take effect. But instead the Fed forced people into risk taking, and the combination of risk taking and weak resolve had the anticipatable effect when the first doubts reared their heads.

In May, Chairman Bernanke indicated that with the economy performing acceptably, the Fed's bond buying might soon taper off, implying that higher interest rates were acceptable. This shouldn't have come as a surprise, since when recovery occurs, a reduction of stimulus should be anticipated. The stock and bond markets' subsequent dramatic swoons showed that the fundamental confidence underlying investors' holdings of risk assets had been weak and vulnerable, and that there had been too much reliance on the Fed keeping rates low. All of a sudden investors were less sure the world looked right, what the future held, and how to make money in it.

Investors remain uncertain, and that's good. Now that a bout of worry has been experienced, the credit markets are healthier (e.g., offering higher returns) than they were two months ago.

If the economy continues to recover and the Fed's bond buying eases off, interest rates are likely to go further on the upside. But given the modest level of confidence at play, the markets should not turn out to be perilous. Most assets are neither dangerously elevated (with the possible exception of long-term Treasury bonds and high grades) nor compellingly cheap. **It's easier to know what to do at the extremes than it is in the middle ground, where I believe we are today. As I wrote in my book, when there's nothing clever to do, the mistake lies in trying to be clever. Today it seems the best we can do is invest prudently in the coming months, avoiding aggressiveness and remembering to apply caution.**

* * *

A word about the long run: While conditions, confidence and asset prices all seem moderate today, meaning there's nothing brilliant to say about the short-term outlook, the long term remains worrisome. Because the U.S. is still able to attract capital from abroad and print money, our financial problems aren't pressing at the moment. But the combination of intractable deficit spending, unsustainable entitlement promises and a total dearth of responsible action in Washington certainly raises alarms regarding the future.

Since I see no reason to reinvent the wheel when someone I respect has said something better than I could, I'll close with a few words from Seth Klarman (emphasis added). Seth doesn't find much in the things he discusses to inspire confidence, and I agree:

> There is no free lunch in economics: if governments could print or borrow money in astronomical amounts without any major adverse consequences, why wouldn't they always do this, forever avoiding downturns while their countries bask in the sunshine of limitless prosperity? Indeed it seems clear that prior misplaced confidence in the Fed contributed greatly to years of complacency that turned the 2008 downturn into a full-blown crisis. Of course there will be a price to pay for today's policy excesses – an equal and opposite reaction. We just haven't seen it yet. Will it take the form of a collapse of the dollar and the end of dollar hegemony, high interest rates, failed auctions of U.S. government securities and runaway inflation, a wrenching and protracted downturn requiring exceptional sacrifice, or something else? We will find out soon enough.
>
> In most sectors of the economy – government, individual but also corporate – the U.S. has borrowed heavily to live beyond its means; we have been consuming through easy credit what we otherwise would have had to wait to buy. In the words of Michael Lewis, "Leverage buys you a glimpse of a prosperity you

haven't really earned." Asset values are contingent, as Jim Grant once said. But debt is forever. Instead of cutting back on leverage and getting our house in order, government response to the crisis has been to shift unaffordable debt from individual balance sheets onto the national ledger, where every day we owe more than ever before. . . .

I believe it is possible that the average citizen understands our country's fiscal situation better than many of our politicians or prominent economists. Most people seem to viscerally recognize that the absence of an immediate crisis does not mean we will not eventually face one. They are wary of believing promises by those who failed to predict previous crises in housing and in highly leveraged financial institutions. They regard with skepticism those who don't accept that we have a debt problem, or insist that inflation will remain under control. (Indeed, they know inflation is not well under control, for they know how far the purchasing power of a dollar has dropped when they go to the supermarket or service station.) They are pretty sure they are not getting reasonable value from the taxes they pay.

When an economist tells them that growing the nation's debt over the past 12 years from $6 trillion to $16 trillion is not a problem, and that doubling it again will still not be a problem, this simply does not compute. They know the trajectory we are on, and that the most successful country in the history of the world can go into decline if it becomes arrogant or complacent. When politicians claim that this tax increase or that spending cut will generate trillions over the next decade, they are properly skeptical over whether anyone can truly know what will happen next year, let alone a decade or more from now. They are wary of grand bargains that kick in years down the road, knowing that the failure to make hard decisions is how we got into today's mess. . . .

And when you tell the populace that we can all enjoy a free lunch of extremely low interest rates, massive Fed purchases of mounting treasury issuance, trillions of dollars of expansion in the Fed's balance sheet, and huge deficits far into the future, they are highly skeptical not because they know precisely what will happen, but because they are sure that no one else – even, or perhaps especially, the policymakers – does either.*

August 5, 2013

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Race Is On

I've written a lot of memos to clients over the last 24 years – well over a hundred. One I'm particularly proud of is *The Race to the Bottom* from February 2007. I think it provided a timely warning about the capital market behavior that ultimately led to the mortgage meltdown of 2007 and the crisis of 2008. I wasn't aware and didn't explicitly predict (in that memo or elsewhere) that the unwise lending practices that were exemplified in sub-prime mortgages would lead to a global financial crisis of multi-generational proportions. However, I did detect carelessness-induced behavior, and I considered it worrisome.

As readers of my memos know, I believe strongly that (a) most of the key phenomena in the investment world are inherently cyclical, (b) these cycles repeat, reflecting consistent patterns of behavior, and (c) the results of that behavior are predictable.

Of all the cycles I write about, I feel the capital market cycle is among the most volatile, prone to some of the greatest extremes. It is also one of the most impactful for investors. **In short, sometimes the credit window is open to anyone in search of capital (meaning dumb deals get done), and sometimes it slams shut (meaning even deserving companies can't raise money).** This memo is about the cycle's first half: the manic swing toward accommodativeness.

An aside: I recently engaged in an exchange with a reader who took issue with my use of the word "cycle." In his view, something is a cycle only if it's so regular that the timing and extent of its ups and downs can be predicted with certainty. The cycles I describe aren't predictable as to timing or extent. However, their fluctuations absolutely can be counted on to recur, and that's what matters to me. I think it's also what Mark Twain had in mind when he said "History doesn't repeat itself, but it does rhyme." The details don't repeat, but the rhyming patterns are extremely reliable.

Competing to Provide Capital

When the economy is doing well and companies' profits are rising, people become increasingly comfortable making loans and investing in equity. As the environment becomes more salutary, lenders and investors enjoy gains. This makes them want to do more; gives them the capital to do it with; and makes them more aggressive. Since this happens to all of them at the same time, the competition to lend and invest becomes increasingly heated.

When investors and lenders want to make investments in greater quantity, I think it's also inescapable that they become willing to accept lower quality. They don't just provide more money on the same old terms; they also become willing – even eager – to do so on weaker terms. **In fact, one way they strive to win the opportunity to put money to work is by doing increasingly dangerous things.**

This behavior was the subject of *The Race to the Bottom*. In it I said to buy a painting in an auction, you have to be willing to pay the highest price. To buy a company, a share of stock or a building – or to make a loan – you also have to pay the highest price. And when the competition is heated, the bidding goes higher. This doesn't always – or exclusively – result in a higher explicit price; for example, bonds rarely come to market at prices above par. Instead, **paying the highest price may take the form of accepting**

a higher valuation parameter (e.g., a higher price/earnings ratio for a stock or a higher multiple of EBITDA for a buyout) **or accepting a lower return** (e.g., a lower yield for a bond or a lower capitalization rate for an office building).

Further, rather than paying more for the asset purchased, **there are other ways for an investor or lender to get less for his money. This can come through tolerating a weaker deal structure or through an increase in risk.** It's primarily these latter elements – rather than securities merely getting pricier – with which this memo is concerned.

History Rhymes

In the pre-crisis years, as described in the 2007 memo, the race to the bottom manifested itself in a number of ways:

- There was **widespread acceptance of financial engineering techniques**, some newly minted, such as derivatives creation, securitization, tranching and selling onward. These innovations resulted in the creation of such things as highly levered mortgage-backed securities, CDOs and CLOs (structured credit instruments offering tiered debt levels of varying riskiness); credit default swaps (enabling investors to place bets regarding the creditworthiness of debtors); and SPACs (Special Purpose Acquisition Companies, or blind-pool acquisition vehicles). Further, the development of derivatives, in particular, vastly increased the ease with which risk could be shouldered (often without a complete understanding) as well as the amount of risk that could be garnered per dollar of capital committed.

- While not a novel development, there was **an enormous upsurge in buyouts**. These included the biggest deals ever; higher enterprise values as a multiple of cash flow; increased leverage ratios; and riskier, more cyclical target companies, such as semiconductor manufacturers.

- There was **widespread structural deterioration**. Examples included covenant-lite loans carrying few or none of the protective terms prudent lenders look for, and PIK-toggle debt on which the obligors could elect to pay interest "in kind" with additional securities rather than cash.

- Finally, there was simply **a willingness to buy riskier securities**. Examples here included large quantities of CCC-rated debt, as well as debt issued to finance dividend payments and stock buybacks. The last two increase a company's leverage without adding any productive assets that can help service the new debt.

Toward the end, my 2007 memo included the following paragraph:

> **Today's financial market conditions are easily summed up: There's a global glut of liquidity, minimal interest in traditional investments, little apparent concern about risk, and skimpy prospective returns everywhere. Thus, as the price for accessing returns that are potentially adequate (but lower than those promised in the past), investors are readily accepting significant risk in the form of heightened leverage, untested derivatives and weak deal structures.** The current cycle isn't unusual in its form, only its extent. There's little mystery about the ultimate outcome, in my opinion, but at this point in the cycle it's the optimists who look best. (emphasis in the original)

Now we're seeing another upswing in risky behavior. It began surprisingly soon after the crisis (see *Warning Flags*, May 2010), spurred on by central bank policies that depressed the return on safe investments. It has gathered steam ever since, but not to anywhere near the same degree as in 2006-07.

- Wall Street has, thus far, been less creative in terms of financial engineering innovations. I can't think of a single new "modern miracle" that's been popularized since the crisis.

- Likewise, derivatives are off the front page and seem to be created at a much slower pace. A full resumption of derivatives creation and other forms of financial innovation appears to be on hold pending clarification of the regulatory uncertainty surrounding acceptable activity for banks.

- Buyout activity seems relatively subdued. In 2006-07, it seemed a buyout in the tens of billions was being announced every week; now they're quite scarce. Many smaller deals are taking place, however, including a large number of "flips" from one buyout fund to another, and leverage ratios have moved back up toward the highs of the last cycle.

- "Cov-lite" and PIK-toggle debt issuance is in full flower, as are triple-Cs, dividend recaps and stock buybacks.

It's highly informative to assess how the other characteristics of 2007 enumerated above compare with conditions today:

- global glut of liquidity – check
- minimal interest in traditional investments – check (relatively little is expected today from Treasurys, high grade bonds or equities, encouraging investors to shift toward alternatives)
- little apparent concern about risk – check
- skimpy prospective returns everywhere – check

Risk tolerance and leverage haven't returned to their pre-crisis highs in quantitative terms, but there's no doubt in my mind that risk bearing is back in vogue.

<u>Examples from the Media</u>

My preparation for writing these memos often includes amassing media citations around a central theme. Here are some from the last few weeks:

- Now, eight years since the PIK-toggle entered the market, companies are again using the esoteric structures, along with a host of riskier borrowing practices associated with the buyout boom that helped inflate the 2006-07 credit bubble. (*Financial Times*, October 22)

- At the same time, more than $200bn of "cov-lite" loans have been sold so far this year, eclipsing the $100bn issued in 2007. That means 56 per cent of new leveraged loans now come with fewer protections for lenders than normal loans. (*Ibid.*)

- Bankers say much of that issuance has been a result of the return of another pre-crisis market vehicle – the collateralised [sic] loan obligation. . . . Like the rest of the leveraged loan market, CLOs have enjoyed buoyant demand. At least $55.41bn of the vehicles have been sold this year – the highest amount since the $88.94bn issued in 2007. (*Ibid.*)

- Bonds rated CCC or lower -- at least eight steps below investment grade -- by S&P have gained 11 percent this year, compared with about a 6 percent gain for all dollar-denominated junk bonds or a loss of more than 1 percent for investment-grade debt, according to Bank of America Merrill Lynch index data. (*Bloomberg*, November 19)

- . . . the amount of indebtedness in leveraged buyout deals is creeping up. The average amount of debt used to finance LBOs has jumped from a low of 3.69 times earnings in 2009 to an average of 5.37 so far this year, according to data from S&P Capital IQ. At the height of the LBO boom, average leverage was 6.05. (*Financial Times*, October 22)

- Subprime loans, given to people with little proven ability to pay, are making a comeback, this time to buy cars. Issuance of bonds linked to loans for the shakiest borrowers hit $17.2 billion this year, more than double the amount sold during the same period in 2010, according to Harris Trifon, a debt analyst at Deutsche Bank AG. (*Bloomberg*, November 19)

- A Goldman Sachs index of [the stocks of] companies with weaker balance sheets has rallied 42 percent this year, almost doubling the gain in a measure of more creditworthy firms. (*Ibid.*)

- Twitter took the first steps in the pricing of its eagerly awaited initial public offering. . . . The social media darling disclosed that it planned to sell 70 million shares at $17 to $20 each. At the midpoint of that range, the offering would raise about $1.3 billion and would value Twitter at about $10 billion, excluding options. . . . Such a valuation would make Twitter more than three times as big as one of the first big Internet giants, AOL . . . (*The New York Times Dealbook*, October 24)

- Twitter is feeling more optimistic about investor appetite for its imminent initial public offering. On Monday morning, the company raised the price range for its I.P.O. to $23 to $25, signaling a bullish outlook ahead of its trading debut this week. The new range increases Twitter's potential market value by several billion dollars. If it prices at the high end, Twitter would be valued at $13.9 billion at the start of its first day of trading. (*Dealbook*, November 4)

- [Twitter] priced its shares at $26 on Wednesday night, giving it a market value of $18.1 billion. On Thursday, Twitter closed at $44.90 a share, 73 percent above its initial public offering price. (*Dealbook*, November 7)

- In a sign of the fervor once again rising around Internet startups, the 23-year-old CEO of [Snapchat] a two-year-old company with no revenue has rejected a $3 billion buyout offer. (*The Wall Street Journal*, November 14)

- Cash is returning to emerging markets, sparking big stock rallies and a surge in fundraising . . . Yield-hungry investors are venturing far into risky territory. Investors snapped up $1.8 billion worth of stock sold by Chinese banks in Hong Kong over the past two weeks, while India's stock market has climbed to record highs. Brazil sold $3.25 billion of debt, its biggest dollar-denominated offering on record, and Pakistan said Monday it plans to sell debt overseas for the first time in six years. (*The Wall Street Journal*, November 7)

- Emerging markets IPOs creep back into London; Emerging market companies are staging a return on the London Stock Exchange after a few quiet years. (*Financial News*, November 5)

Perhaps most tellingly, the November 19 *Bloomberg* story referenced above included the following observation from a strategist whom I'll allow to go nameless: "The analysis at some point shifts from fundamentals to being purely based on the price action of the stock." **When people start to posit that fundamentals don't matter and momentum will carry the day, it's an omen we must heed.**

While the extent is nowhere as dramatic as in 2006-07 – and the psychology behind it isn't close to being as bullish or risk-blind – I certainly sense a significant increase in the acceptance of risk. The bottom line is that when risk aversion declines and the pursuit of return gathers steam, issuers can do things in the capital markets that are impossible in more prudent times.

<u>Why Is Risk Bearing on the Rise, and What Are the Implications?</u>

To set the scene for answering the above questions, I'm going to reiterate and pull together some observations from recent memos.

Psychologically and attitudinally, I don't think the current capital market atmosphere bears much of a resemblance to that of 2006-07. Then I used words like "optimistic," "ebullient" and "risk-oblivious" to describe the players. Returns on risky assets were running high, and a number of factors were cited as having eliminated risk:

- The Fed was considered capable of restoring growth come what may.
- A global "wall of liquidity" was coming toward us, derived from China's and the oil producers' excess reserves; it could be counted on to keep asset prices aloft.
- The Wall Street miracles of securitization, tranching, selling onward and derivatives creation had "sliced and diced" risk so finely – and directed it where it could most readily be borne – that risk really didn't require much thought.

In short, in those days, most people couldn't imagine a way to lose money.

I believe most strongly that the riskiest thing in the investment world is the belief that there's no risk. When that kind of sentiment prevails, investors will engage in otherwise-risky behavior. By doing so, they make the world a risky place. And that's what happened in those pre-crisis years. When *The New York Times* asked a dozen people for articles about the cause of the crisis, I wrote one titled "Too Much Trust; Too Little Worry." Certainly a dearth of fear and a resulting high degree of risk taking accurately characterize the pre-crisis environment. But that was then. It's different today.

Today, unlike 2006-07, uncertainty is everywhere:

- Will the rate of economic growth in the U.S. get back to its prior norm? Will unemployment fall to the old "structural" level?
- Can America's elected officials possibly reach agreement on long-term solutions to the problems of deficits and debt? Or will the national debt expand unchecked?
- Will Europe improve in terms of GDP growth, competitiveness and fiscal governance? Will its leaders be able to reconcile the various nations' opposing priorities?
- Can Abenomics transform Japan's economy from lethargy to dynamism? The policies appear on paper to be the right ones, but will they work?

- Can China transition from a highly stimulated economy based on easy money, an excess of fixed investment and an overactive non-bank financial system, without producing a hard landing that keeps it from reaching its economic goals?
- Can the emerging market economies prosper if demand from China and the developed world expands more slowly than in the past?

Looking at the world more thematically, a lot of questions surround the ability to manage economies and regulate growth:

- Can low interest rates and high levels of money creation return economic growth rates to previous levels? (To date, the evidence is mixed.)
- Can inflation be returned to a salutary level somewhat above that of today? Right now, insufficient inflation is the subject of complaints almost everywhere. Can the desired inflation rate be reinstated without going beyond, to undesirable levels?
- Programs like Quantitative Easing are novel inventions. How much do we know about how to end them, and about what the effects of doing so will be? Will it prove possible to wind down the stimulus – the word du jour is "taper" – without jeopardizing today's unsteady, non-dynamic recoveries? Can the central banks back off from interest rate suppression, bond buying and easy money policies without causing interest rates to rise enough to choke off growth?
- How will governments reconcile the opposing goals of stimulating growth (lower taxes, increased spending) and reining in deficits (increased taxes, less spending)?
- Will prosperous regions (e.g., Germany) continue to be willing to subsidize profligate and poorer ones (e.g., Spain and Portugal)?

As to investments:

- When the Fed stops buying bonds, will interest rates rise a little or a lot? Does that mean bonds are unattractive?
- Are U.S. stocks still attractive after having risen strongly over the last 18 months?
- Ditto for real estate following its post-crash recovery?
- Can private equity funds buy companies at attractive prices in an environment where few owners are motivated to sell?

As I've said before, most people are aware of these uncertainties. Unlike the smugness, complacency and obliviousness of the pre-crisis years, today few people are as confident as they used to be about their ability to predict the future, or as certain that it will be rosy. **Nevertheless, many investors are accepting (or maybe pursuing) increased risk.**

The reason, of course, is that they feel they have to. The actions of the central banks to lower interest rates to stimulate economies have made this a low-return world. This has caused investors to move out on the risk curve in pursuit of the returns they want or need. Investors who used to get 6% from Treasurys have turned to high yield bonds for such a return, and so forth.

Movement up the risk curve brings cash inflows to riskier markets. Those cash inflows increase demand, cause prices to rise, enhance short-term returns, and contribute to the pro-risk behavior described above. **Through this process, the race to the bottom is renewed.**

<u>**In short, it's my belief that when investors take on added risks – whether because of increased optimism or because they're coerced to do so (as now) – they often forget to apply the caution they**</u>

should. That's bad for them. But if we're not cognizant of the implications, it can also be bad for the rest of us.

Where does investment risk come from? Not, in my view, primarily from companies, securities – pieces of paper – or institutions such as exchanges. No, in my view the greatest risk comes from prices that are too high relative to fundamentals. And how do prices get too high? Mainly because the actions of market participants take them there.

Among the many pendulums that swing in the investments world – such as between fear and greed, and between depression and euphoria – one of the most important is the swing between risk aversion and risk tolerance.

Risk aversion is the essential element in sane markets. People are supposed to prefer safety over uncertainty, all other things being equal. When investors are sufficiently risk averse, they'll (a) approach risky investments with caution and skepticism, (b) perform thorough due diligence, incorporating conservative assumptions, and (c) demand healthy incremental return as compensation for accepting incremental risk. This sort of behavior makes the market a relatively safe place.

But when investors drop their risk aversion and become risk-tolerant instead, they turn bold and trusting, fail to do as much due diligence, base their analysis on aggressive assumptions, and forget to demand adequate risk premiums as a reward for bearing increased risk. **The result is a more dangerous world where asset prices are higher, prospective returns are lower, risk is elevated, the quality and safety of new issues deteriorates, and the premium for bearing risk is insufficient.**

It's one of my first principles that we never know where we're going – given the unreliability of macro forecasting – but we ought to know where we are. "Where we are" means what the temperature of the market is: Are investors risk-averse or risk-tolerant? Are they behaving cautiously or aggressively? And thus is the market a safe place or a risky one?

Certainly risk tolerance has been increasing of late; high returns on risky assets have encouraged more of the same; and the markets are becoming more heated. The bottom line varies from sector to sector, but I have no doubt that markets are riskier than at any other time since the depths of the crisis in late 2008 (for credit) or early 2009 (for equities), and they are becoming more so.

Is This a Sell Signal? If Not, Then What?

No, I don't think it's time to bail out of the markets. Prices and valuation parameters are higher than they were a few years ago, and riskier behavior is observed. But what matters is the degree, and I don't think it has reached the danger zone yet.

First, as mentioned above, the absolute quantum of risk doesn't seem as high as in 2006-07. The modern miracles of finance aren't seen as often (or touted as highly), and the use of leverage isn't as high.

Second, prices and valuations aren't highly extended (the p/e ratio on the S&P 500 is around 16, the post-war average, while in 2000 it was in the low 30s: now that's extended).

A rise in risk tolerance is something that should get your attention and focus your concentration. But for it to be highly worrisome, it has to be accompanied by extended valuations. I don't think we're there yet. **I think most asset classes are priced fully – in many cases on the high side of fair – but not at bubble-type highs.** Of course the exception is bonds in general, which the central banks are supporting at yields near all-time lows, meaning prices near all-time highs. But I don't find them scary (unless their duration is long), since – if the issuers prove to be money-good – they'll eventually pay off at par, erasing the interim mark-downs that will come when interest rates rise.

* * *

In the 1950s, when I was a kid, I watched old movies on TV when I got home from school. One from the 1940s was called *It Happened Tomorrow*. In it, a struggling young journalist made a deal with the devil to be given a peek at the next day's news. His scoops brought him huge success, and everything ran smoothly until he received a newspaper headlined "Reporter Shot Dead at Racetrack." He tried all he could to avoid it, but as a result of some very clever plot devices, he of course ended up at the track (where he learned that the headline had resulted from a case of mistaken identity).

I go through all of the above to explain that – try as I might to avoid it – my memos on excessive risk bearing and what to do about it invariably end up back at the same place: my favorite Buffettism:

> . . . the less the prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.

I repeat Warren's injunction for the simple reason that you just can't put it any better. When others are acting imprudently, making the world a riskier place, our caution level should rise in response. (It's equally true that when others become overly cautious and run from risk, assets get so cheap that we should turn aggressive.)

Over the last 2-3 years, my motto for Oaktree has been consistent: "move forward, but with caution." I feel the outlook is not so bad, and asset prices are not so high, that it's time to apply maximum caution (or, as they said in *The Godfather*, "go to the mattresses"). But by the same token, the outlook is not so good, and asset prices are not so low, that we should be aggressive. That's the reason for my middling stance.

Having said that, however, there's no doubt in my mind that the trend is in the direction of increased risk, and I see no reason to think that trend will be arrested anytime soon. Risk is likely to reach extreme levels someday – it always does, eventually – and great caution will be called for. Just not yet.

Here's my conclusion from *The Race to the Bottom*. I'll let it stand – another case of "ditto."

> . . . there's a race to the bottom going on, reflecting a widespread reduction in the level of prudence on the part of investors and capital providers. No one can prove at this point that those who participate will be punished, or that their long-run performance won't exceed that of the naysayers. But that is the usual pattern.

November 26, 2013

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Memo to: Oaktree Clients

From: Howard Marks

Re: Getting Lucky

Sometimes these memos are inspired by a single event or just one thing I read. This one – like my first memo 24 years ago – grew out of the juxtaposition of two observations. I'll introduce one here and the other on page seven. Contrary to my wife Nancy's observation that my memos are "all the same," the subject here is one I've rarely touched on.

The Role of Luck

The first inspiration for this memo came in early November, when I picked up a copy of the *Four Seasons Magazine* in my hotel room in Riyadh, Saudi Arabia. I happened to turn to an article entitled "In Defence of Luck" by Ed Smith. It's been in my Oaktree bag ever since. In his two opening paragraphs, Smith presents a thesis for dismantling:

> "Success is never accidental," Twitter founder Jack Dorsey recently tweeted. No accidents, just planning; no luck, only strategy; no randomness, just perfect logic.
>
> It is a tempting executive summary for a seductive speech or article. If there are no accidents, then winners are seen in an even better light. Denying the existence of luck appeals to a fundamental human urge: to understand, and ultimately control, everything in our path. Hence the popularity of the statement "You make your own luck."

That's all it took to get my juices flowing. I – along with Smith – believe a great many things contribute to success. Some are our own doing, while many others are beyond our control. There's no doubt that hard work, planning and persistence are essential for repeated success. These are among the contributors that Twitter's Dorsey is talking about. But even the hardest workers and best decision makers among us will fail to succeed consistently without luck.

What are the components of luck? They range from accidents of birth and genetics, to chance meetings and fortuitous choices, and even to perhaps-random but certainly unforeseeable events that cause decisions to turn out right.

In discussing the existence and importance of luck, Smith cites the popular book *Outliers* by Malcolm Gladwell:

> Attacking luck has never been more fashionable. No matter how flimsy the science behind the theory, popularized by author Malcolm Gladwell, that success must follow from 10,000 hours of dedicated practice, it has hardened into folklore.

Outliers is best known for Gladwell's observation that it's this magic number of hours of practice that makes the difference for those who are most successful. But that's only part of Gladwell's message, and people who think his book is all about hard work and practice miss the point. Having set out the "10,000-hours" thesis, Gladwell largely stops talking about it and turns to spend much more time on something he calls "demographic luck." This is actually the antithesis of an insistence that hours of effort suffice.

Demographic Luck

Gladwell's term for this key ingredient in success has a simpler everyday label: "being born at the right time and the right place." Gladwell's examples are compelling:

- By the time the first hockey tryouts take place for all the little Canadian boys born in a given calendar year, those born in January will be eleven months older – and thus much bigger and stronger and more coordinated – than those born in December. They're likely to be put on better teams, receive better coaching, and spend more time on the ice. They're more likely to get 10,000 hours of practice and – all other things equal – to have their skills honed and showcased.

- When I went to college in the mid-sixties, we inputted computer projects via punch cards; they ran overnight; and we went back for our results the next morning. But going to a private high school a few years later enabled Bill Gates to enter his work via a time-sharing terminal connected directly to a central computer, and to see the results in real time. Thus he could perform hundreds of iterations a week, not seven, and develop his skills and his ideas much faster. In addition, the University of Washington was a short bus ride from his home, and his family's contacts enabled him to use its computer lab.

- When Joe Flom and his Jewish cohorts graduated from law school in the 1930s, there were no jobs for them with prestigious Wall Street law firms. They formed their own firm, Skadden, Arps, Slate, Meagher and Flom, but their work was largely confined to matters the "white shoe" firms rejected as unseemly and disreputable. Thus when proxy fights and hostile takeovers became commonplace in the 1970s and '80s, Joe Flom had superior experience and became a leader in advising on them, earning multi-million dollar fees.

It seems like more than a coincidence that not only was Bill Gates born in 1955, but his Microsoft co-founder Paul Allen was born in 1953; Sun Microsystems founders Bill Joy and Scott McNealy were born in 1954; Steve Jobs and Eric Schmidt were born in 1955; and Steve Ballmer was born in 1956. Ten years earlier and there would have been no remote computer terminals for them to work at in high school and college; ten years later and the kids born before them would have beat them to the "new, new thing."

Likewise, the greatest pioneers of the M&A bar were born at the right time to benefit from the upsurge in corporate activities that the legal establishment had frowned upon: Joe Flom in 1923 and all four founders of Wachtell, Lipton, Rosen and Katz in 1930-31.

During the holidays, I enjoyed spending time with three legends of the pop music business: producer David Geffen, entertainment attorney Allen Grubman, and Robbie Robertson, leader of the group "The Band." I was struck by the fact that they were all born in the same year: 1943. I came along three years later, and I remember my parents picking me up from summer camp in 1956 and telling me about a new singing sensation, Elvis Presley, and a new kind of music called rock and roll. The three men listed above were born at the right time to become leaders of the newly minted rock and roll industry. It's a good thing they weren't born a few decades later, since cheap downloads and file sharing have now decimated the profitability of the record business.

The bottom line is simple: it's great to be in the vanguard of a new development. Talent and hard work are essential, but there's nothing like getting there early and being pushed ahead by the powerful trends in demographics and taste that follow.

Perhaps the ultimate description of demographic luck comes from Warren Buffett:

> I've had it so good in this world, you know. The odds were fifty-to-one against me being born in the United States in 1930. I won the lottery the day I emerged from the womb by being in the United States instead of in some other country where my chances would have been way different.
>
> Imagine there are two identical twins in the womb, both equally bright and energetic. And the genie says to them, "One of you is going to be born in the United States, and one of you is going to be born in Bangladesh. And if you wind up in Bangladesh, you will pay no taxes. What percentage of your income would you bid to be the one that is born in the United States?" It says something about the fact that society has something to do with your fate and not just your innate qualities. The people who say, "I did it all myself," and think of themselves as Horatio Alger – believe me, they'd bid more to be in the United States than in Bangladesh. That's the Ovarian Lottery. (*The Snowball*, Alice Schroeder)

Buffett is insightful enough to realize – and secure enough to admit – that he isn't solely responsible for his success. What if he'd been born in Bangladesh instead of the U.S.? Or a woman rather than a man in 1930, having much fewer opportunities? Or in 1830 (when there would be no hedge fund industry for a century) or 2014 (when there are smart people crawling all over it)? Or to different parents? Or if he'd missed out on studying under Ben Graham at Columbia? Or if he hadn't partnered with Charlie Munger?

I'm impressed when people credit others – as well as luck – for the essential part they played in their accomplishments. And I agree 100% with the following sentiment from Smith's article:

> Michael Young, the sociologist who coined the term "meritocracy," described the danger of thinking that success must be deserved just because it has happened: "If meritocrats believe, as more and more of them are encouraged to, that their advancement comes from their own merits . . . **they can be insufferably smug**." (Emphasis added)

Did You Do It All Yourself?

Buffett's mention of "people who say, 'I did it all myself' " reminds me of one of President Obama's reelection campaign speeches, which included a comment that became a lightning rod: "If you've got a business – you didn't build that. Somebody else made that happen."

His remark serves quite poorly when taken on its own. It suggests he thinks that there's no such thing as individual success, only group accomplishments. It denies the efficacy of hard work and grit. In short, it reflects a very un-American view of success.

It's hard to be sure that every sentence we speak or write can stand on its own. When taken in context, Obama's statement makes more sense:

> If you were successful, somebody along the line gave you some help. There was a great teacher somewhere in your life. Somebody helped to create this unbelievable American system that we have that allowed you to thrive. Somebody invested in roads and bridges. If you've got a business – you didn't build that. Somebody else made that happen.

Clearly Obama omitted a few key words from those two last sentences, perhaps assuming his listeners would carry them over from those that went before. The addition of just four words (italicized below) would have made his message more palatable: "If you've got a business – you didn't build that *alone*. Somebody else *provided assistance that* made that happen."

In other words, you were lucky enough to get help. Weren't we all?

Did I Do It All Myself?

You may think of me as intelligent, insightful and/or hard-working. I hope you do. But when I finished reading *Outliers*, I was moved to write down for my kids all the ways in which demographic luck contributed to my success. To illustrate my point, I want to share the list with you:

- First of all, it was great to be born in America at the very beginning of the "baby boom." Baby boomers – the generation born right after World War II – benefitted from the return of servicemen from the war; the ending of war-time limits on consumption; and explosive subsequent growth of the population, which fired strong economic growth. I was conceived during the war and born just after it ended. You couldn't get much closer to the front of the line.

- I was born to middle-class parents – members of the first generation in their families to be born in America – who encouraged me in education and work. They made me the first member of our family to receive a college degree.

- The timing of my birth enabled me to get a good, free education in the New York City public schools. The schools benefitted from the presence of smart women teachers to whom corporate careers weren't available, and who liked being on the same vacation schedule as their kids.

- My high school guidance counselor said my grades weren't good enough to get me into Wharton, but I was lucky to have had an accounting teacher whose letter of recommendation may have done the trick. Or perhaps it was the college entrance exams or SATs, standardized tests that had been introduced shortly before to counter the elite universities' bias against public-school kids.

- Regardless of what made it possible, it's clear that attending Wharton taught me a lot, exposed me to finance (previously I had planned on a career in accounting) and burnished my resume. Would my career, and thus my life, have been the same if I hadn't gotten into Wharton and instead had attended my second-choice school, a large state university?

- When I went off to college, I'd never heard of something called an MBA. But the existence of the Vietnam War provided an incentive to stay in school, and three years for law school seemed like too much, so business school it would be. Turned down by Harvard because of my lack of work experience, I instead attended the University of Chicago, whose theoretical, quantitative approach provided the perfect complement to my pragmatic Wharton undergraduate education.

- Just as I was lucky to be at the front of the line of baby boomers, my timing was fortuitous in attending Chicago. I arrived on campus in 1967, just a few years after the new Chicago approach to finance had begun to be taught. No more than a few hundred students could have beat me to the capital asset pricing model, modern portfolio theory, the efficient market hypothesis, the random walk, and the other components of today's investment theory.

- I’m not one of those investors who started reading prospectuses at age ten. In fact, even as I approached graduation from Chicago in 1969, I was unsure of my career direction. I accepted a permanent position in investment research at First National City Bank (the predecessor of Citibank), largely because I’d had a good summer job there a year earlier. Ten years in equity analysis there, including three as director of research, provided an ideal foundation for my investment career.

- And then, when a new chief investment officer wanted to make room for his own head of research in 1978, he asked me to start up funds in convertible bonds and – in the ultimate stroke of luck – the newly created field of high yield bonds. How could anyone have been better positioned to participate in the financial developments of the last 35 years?

- And of course, I was at my luckiest when I teamed up with my wonderful partners – Bruce Karsh, Sheldon Stone, Larry Keele and Richard Masson – between 1983 and 1988. Bruce had the idea to organize a fund to invest in “distressed debt” at TCW, the first one from a mainstream financial institution. And then the five of us left to start Oaktree in 1995. The rest, as they say, is history.

You make your own luck? Success is never accidental? Bull!! I contributed to some of the positive developments described above, but many of them were pure luck. Pull out a few of the steps on this progression, and where would I be today? Here’s one more: Of all the jobs I applied for when leaving Chicago in 1969, I wanted one much more than the rest but didn’t get it. A few years ago, the company’s campus recruiter told me I had been chosen, but on the relevant morning the partner in charge came in hung over and failed to call me with the positive message he was supposed to deliver. **Just think: but for that bit of “bad luck” I could have spent the next 39 years at Lehman Brothers!**

I know how lucky I’ve been. I find it incredibly uplifting and the source of great optimism regarding the future to know and appreciate my good fortune. Rather than detract from my satisfaction over the success I’ve enjoyed – because of having to admit it wasn’t all my own doing – this realization makes me feel fortunate to have been born when and where I was and to have benefitted from the developments that came along. I revel in my good luck.

And what about the things I may have brought to my career: perhaps intelligence, insight and a talent for writing? **Isn’t having these things a form of luck?** Intelligent and innately talented people didn’t do anything to earn their gifts. No one can take credit for them as “something I did” or “something that was within my control.” These things, too, are luck, and something for which we should give thanks rather than take credit.

Luck in Investing

Rather than “you make your own luck,” there’s an old saying that provides a better way to put it: “luck is what happens when preparation meets opportunity.” If you prepare through study and practice, work hard and bring your talents to bear, you’ll be positioned to make the most out of opportunities that arise. This way of looking at life is in line with my formulation regarding investment results: **performance is what happens when events collide with an existing portfolio**.

We arrange our lives – or, in investing, our portfolios – in expectation of what we think will happen in the future. In general, we get the desired results if future events conform to our hopes or expectations, and less-desired results if they don’t.

What about people – like those of us at Oaktree – who don't consider themselves macro forecasters or market timers? Even the most devoted value investor acts on the basis of expectations: that an asset selling at x will turn out to be worth 2x, and that one of these days everyone else will recognize its value and bid it up. And the agnostic buy-and-hold equity investor operates under the assumption that the economy will expand, companies will increase their profits, and stock prices will rise as a result.

Let's say investors reach their conclusions about current intrinsic value or future earnings growth by applying skillful analysis to accurate data and reasonable assumptions. Let's grant, in short, that their conclusions are "right" in some abstract sense. It still takes a great deal of luck for their version of future events to materialize.

Elroy Dimson of the London Business School is responsible for one of the most trenchant observations: "Risk means more things can happen than will happen." In other words, the future isn't a predetermined scenario that's sure to unfold, but rather a range of possibilities, any one of which may happen. Investors formulate opinions as to which of them will happen. Those opinions may be well-reasoned or dart throws. But even the most rigorously derived view of the future is far from sure to be right. Many other things may happen instead.

Nassim Nicholas Taleb's views, expressed in *Fooled by Randomness*, connect up with Dimson's. The world is an uncertain, even random, place. What "should happen" might be totally clear, meaning we know what the future should hold. But the things that should happen may not happen – and other things may happen instead – for any of a variety of reasons, many of them extraneous, unpredictable and even nonsensical**. Those things can be described as random: the result of luck, either good or bad.**

The point is that we assemble our portfolios, and future events determine whether our performance will be rewarded or punished. People whose expectations are borne out generally make money, and those whose aren't lose. That process sounds very fact-based, meritocratic and luck-free, and thus dependable. But that's only the case on average and in the longest-term sense.

- Sometimes, even though an investor's projections may be far too optimistic relative to what he should have expected – a.k.a. "wrong" – the investor is bailed out by unforeseeable positive developments, or even by non-fundamentally based price appreciation. Either way, the stock rises and the investor is applauded. I'd say he was "right for the wrong reason" (or "lucky").
- Alternatively, a prudent, skillful investor may formulate a reasonable view of the future, only to see the world go off the rails and his investments fail. He might be described as "wrong for the wrong reason" (or "unlucky").
- An investor may take an appropriately cautious stance – let's say toward tech stocks in 1997 or residential mortgage backed securities in 2005 – only to see an irrationally overpriced market become more so, as prices soar for years. He looks terrible, a victim of the old adage that "being too far ahead of your time is indistinguishable from being wrong."
- Further, in a special case of being wrong as to timing although perhaps not fundamentals, an investor may take a concentrated position in a laughably underpriced stock, using a huge amount of borrowed money. But before the expected appreciation can take place, a market crash brings on a margin call, and he's wiped out. As John Maynard Keynes said, "The market can remain irrational longer than you can remain solvent."
- Last year marked the passing of Joe Granville, a technical analyst whose warning in 1976 was followed by a 26% two-year decline, winning him respect and fame. But his next accurate call wouldn't come for 24 years, when he told people to sell tech stocks in 2000. Was it skill back in 1976, or a lucky call that turned out right when events went his way? Regardless, he became one of many in the investment business who get famous for having been "right once in a row."

The first thing I remember learning at Wharton in 1963 was that the correctness of a decision can't be judged from the outcome. Because of the randomness at work in the world and the unpredictability of the future, lots of bad decisions lead to good results, and lots of good decisions end in failure.

In other words, for an investor to both be right *and* make money:

- his view of what will happen in the future – and what should be done about it – has to be analytically correct *a priori*,
- the things he thinks will happen have to actually happen, and
- those things have to happen on schedule.

But in investing, it's hard to know what will happen and impossible to know *when* it will happen. Many things influence performance other than (a) investors' hard work and skill and (b) the market's dependable discounting of information about the future. Luck – randomness, or the occurrence of things beyond our knowledge and control – plays a huge part in outcomes.

Investment success isn't just a question of whether the investor put together the "right" portfolio, but also whether it encountered a beneficial environment. Thus being successful requires a significant degree of luck. No one gets it right every time. (That's why even the best investors diversify, hedge and/or limit their use of leverage.) But the skillful investor is right more often, over a long period of time, than an assumption of randomness would permit. **We say about such investors, "it can't be luck."**

* * *

<u>Where Is It Easiest to Get Lucky?</u>

The second inspiration for this memo came from a report entitled *Alpha and the Paradox of Skill* by Michael Mauboussin of Credit Suisse. In it he talks about Jim Rutt, the CEO of Network Solutions. As a young man, Rutt wanted to become a better poker player, and to that end he worked hard to learn the odds regarding each hand and how to detect "tells" in other players that give away their position.

Here's the part that attracted my attention:

> At that point, an uncle pulled him aside and doled out some advice. "Jim, I wouldn't spend my time getting better," he advised, **"I'd spend my time finding weak games."**
>
> Success in investing has two aspects. The first is skill, which requires you to be technically proficient. Technical skills include the ability to find mispriced securities (based on capabilities in modeling, financial statement analysis, competitive strategy analysis, and valuation all while sidestepping behavioral biases) and a good framework for portfolio construction. **The second aspect is the game in which you choose to compete**. (Emphasis added)

Mauboussin goes on to talk primarily about changes in the relative importance of luck and skill. But for me, what his words keyed first and foremost were musings about market efficiency and inefficiency. What they highlighted is that the easiest way to win at poker is by playing in easy games in which other players make mistakes. **Likewise, the easiest way to win at investing is by sticking to inefficient markets.**

Luck and Efficiency

Here's my take on the efficient market hypothesis: Thousands of intelligent, computer-literate, objective, unemotional, highly motivated and hard-working investors spend a great deal of time searching for information about assets and analyzing what it means for their value. For this reason, all available information is incorporated instantaneously in market prices. This causes the market price of every asset to accurately reflect its intrinsic value, such that an investor in the asset will enjoy a risk-adjusted return that is fair relative to the return on all other assets: no more and no less. Thus there are no "inefficiencies," or instances where assets are priced incorrectly so as to provide an "excess return" or a "free lunch." For this reason, no individuals are able to demonstrate superior investment skill ("alpha"). Even if some people were smart enough to take advantage of pricing errors, the market doesn't present errors for them to take advantage of. As a result, nobody can beat the market.

I have one main disagreement with the theory as presented above. Whereas the academics say in an efficient market the price of each asset **accurately reflects** its intrinsic value, I say the price set by the consensus **does the best job of estimating** the asset's intrinsic value. In other words, the academics say market prices are right, while I say they may be wrong but can't consistently be improved upon (and the errors taken advantage of) by any individual. A market may not be efficient in the sense that prices are "right," but it can be efficient in that it swiftly incorporates new information. The resulting prices may not be equal to the value, but they reflect everyone's best collective thinking at a point in time. **The result is the same: no one can beat the market.**

I think of the test for market efficiency as being twofold: if markets are efficient, (a) one market's risk-adjusted return can't be better or worse than any other market and (b) no investor in the market can outperform the rest in risk-adjusted terms. **In other words, there can't be opportunities for outperformance . . . either through skill or luck. In an efficient market – as with a Swiss watch (or, as Taleb would say, in dentistry) – luck plays no part.**

Are Markets Efficient? Is the Hypothesis Relevant?

Let me say up front that I have always considered the reasoning behind the efficient market hypothesis absolutely sound and compelling, and it has greatly influenced my thinking.

In well-followed markets, thousands of people are looking for superior investments and trying to avoid inferior ones. If they find information indicating something's a bargain, they buy it, driving up the price and eliminating the potential for an excess return. Likewise, if they find an overpriced asset, they sell it or short it, driving down the price and lifting its prospective return. **I think it makes perfect sense to expect intelligent market participants to drive out mispricings.**

The efficient market hypothesis is compelling . . . as a hypothesis. But is it relevant in the real world? (As Yogi Berra said, "In theory there is no difference between theory and practice, but in practice there is.") The answer lies in the fact that no hypothesis is any better than the assumptions on which it's premised.

I believe many markets are quite efficient. Everyone is aware of them, basically understands them, and is willing to invest in them. And in general everyone gets the same information at the same time (in fact, it's one of the SEC's missions to make sure that's the case). I had markets like that in mind in 1978 when, on going into portfolio management, my rule was, "I'll do anything but spend the rest of my life choosing between Merck and Lilly."

But I also believe some markets are less efficient than others. Not everyone knows about them or understands them. They may be controversial, making people hesitant to invest. They may appear too risky for some. They may be hard to invest in, illiquid, or accessible only through locked-up vehicles in which some people can't or don't want to participate. Some market participants may have better information than others . . . legally. **Thus, in an inefficient market there can be mastery and/or luck, since market prices are often wrong, enabling some investors to do better than others.**

(Time for an aside: the fact that a market is inefficient doesn't mean everyone in it gets rich. It simply means there are overpricings and underpricings, to profit from or fall victim to. Thus there can be winners *and losers*. Even in an inefficient market, not everyone can be above average.)

Ultimately, there's one reason why I think no markets are perfectly efficient. Remember the assumptions underlying market efficiency: the participants have to be objective and unemotional. Regardless of the market, few investors pass that test. How many are unemotional enough to resist buying into a fast-rising bubble, or selling in a crash when the price of an asset appears to be on the way to zero?

The bottom line for me is that (a) you mustn't ignore the concept of efficiency, and at the same time, (b) you mustn't accept it as universally true. As I wrote in *What's It All About, Alpha* (July 2001):

> If we entirely ignore theory, we can make big mistakes. We can fool ourselves into thinking it's possible to know more than everyone else and regularly beat heavily populated markets. . . . But swallowing theory whole can make us turn the process over to a computer and miss out on the contribution skillful individuals can make.

Rather than expect markets to routinely provide a free lunch, I think there should be a presumption that they're efficient. The burden of proof should be on anyone who thinks a market provides underpriced investments that no one else is smart enough to detect and pursue. It's safer to be skeptical of the existence of freebies than to assume unappreciated bargains are rife for the taking.

It's important to note, however, that market efficiency shouldn't be considered something that's universally applicable, but rather what Bruce Karsh has taught me to call a "rebuttable presumption." You should start out thinking it's the general rule, but its applicability can be disproved in individual situations. The possibility of inefficiency shouldn't be ignored.

In the old story on this subject, the professor of finance theory is taking a walk across the campus with one of his students. The student says, "Look professor: isn't that a $10 bill on the ground?" The professor answers, "It can't be a $10 bill. If it were, someone would have picked it up by now." The professor turns and walks away, and the student picks it up and has a beer.

<u>My History with Inefficiency</u>

As mentioned above, I was lucky in 1978 when Citibank asked me to manage a portfolio for the brokerage house Bache, which wanted to offer a high yield bond mutual fund. This was the first of many opportunities I've enjoyed for free lunches.

Thirty-five years ago, the high yield bond market was a classic example of market inefficiency.

- It was little known and little researched.
- There was little reported performance history.
- There was no centralized trading and no reported data on prices.
- Few professionals invested in them.
- Most importantly, high yield bonds were viewed as unseemly and investing in them was considered improper. I'll never forget Moody's definition of a B-rated bond: "fails to possess the characteristics of a desirable investment."
- For this reason, they were banned under most institutions' policies, which limited investment to bonds rated "A or better" or "investment grade (triple-B or better)."
- And, of course, they were known by the derogatory term "junk bonds." Like the finance professor in the story, most investors turned up their noses and walked away.

The elements listed above caused high yield bonds to be disrespected and shunned, **and thus to be underpriced and offer yields that were too high for the risk involved**. How do I know? Because (a) the yield spread offered as compensation for bearing risk has proved to be excessive, (b) the bonds have outperformed other forms of fixed income investing over the long term, and (c) Sheldon Stone has been able to compile a risk-adjusted net return above his benchmarks for the 28 years over which he's managed our portfolios. High yield bonds have provided the foundation for much of Oaktree's success and many of its subsequent initiatives.

Ten years later, in 1988, Sheldon and I agreed with Bruce Karsh that we should organize our first distressed debt fund, and Bruce hired Richard Masson to join him in the task. While the prominence of Drexel Burnham and Michael Milken had attracted attention to high yield bonds by that time, distressed debt was still little known and poorly understood. What could be more unseemly and frightening than the debt of companies that were bankrupt or that appeared overwhelmingly likely to become so? No mainstream financial institutions invested in distressed debt or offered distressed debt funds, leaving an open playing field for us. Bruce's aggregate since-inception return of 23% per year before fees (17½% after) – without the benefit of leverage – certainly suggests that inefficiencies have been present. And the fact that he has earned that return over 25 years while investing $35 billion says it wasn't luck.

My point here is that these markets – and others that Oaktree entered over the years – have been inefficient markets. The lack of information, infrastructure, understanding and competition created many opportunities for us to find bargains, and for our clients in those markets to enjoy favorable returns with less-than-commensurate risk.

<u>The Durability of Inefficiency</u>

If efficiency should be the going-in presumption, so should "efficientization." That's my term for the process through which a market becomes more efficient. In short, over time the actions of diligent investors should have the effect of driving out bargains. If at first bargains exist, their holders will enjoy superior risk-adjusted returns, other investors will take note, and they'll study them and bid them up enough to eliminate the bargain element and thus the potential for further excess returns. If the inefficiency is caused by underdeveloped market infrastructure, you can expect centralized trading, price reporting, performance data and consultant focus to develop.

It requires a certain degree of malfunction for the market to allow an investor to find a bargain, buy it on the cheap and enjoy an excess return. But it takes a much greater degree of malfunction

for everyone else to fail to notice that investor's success, fail to emulate his methods, and thus allow the bargain to persist. Usually a free-lunch counter should be expected to be picked clean.

<u>The Current State of Market Efficiency</u>

Let's compare the current environment for efficiency with that of the past.

- Data on all forms of investing is freely available in vast quantities.
- Every investor has extensive computing power. In contrast, there were essentially no PCs or even four-function calculators before 1970, and no laptops before 1980.
- "Hedge fund," "alternative investing," "distressed debt," "high yield bond," "private equity," "mortgage backed security" and "emerging market" are all household words today. Thirty years ago they were non-existent, little known or poorly understood. Today, as I say about the impact of the browsers on our mobile phones, "everyone knows everything."
- Nowadays few people make moral judgments about investments. There aren't many instances of investors turning down an investment just because it's controversial or unseemly. In contrast, most will do anything to make a buck.
- There are about 8,000 hedge funds in the world, many of which have wide-open charters and pride themselves on being infinitely flexible.

It's hard to prove efficiency or inefficiency. Among other reasons, the academics say it takes many decades of data to reach a conclusion with "statistical significance," but by the time the requisite number of years have passed, the environment is likely to have been altered. Regardless, I think we must look at the changes listed above and accept that the conditions of today are less propitious for inefficiency than those of the past. **In short, it makes sense to accept that most games are no longer as easy as they used to be, and that as a result free lunches are scarcer. Thus, in general, I think it will be harder to earn superior risk-adjusted returns in the future, and the margin of superiority will be smaller.**

People often ask me about the inefficient markets of tomorrow. Think about it: that's an oxymoron. It's like asking, "What is there that hasn't been discovered yet?" **The markets are greatly changed from 25, 35 or 45 years ago. The bottom line today is that there's little that people don't know about, understand and embrace.**

How, then, do I expect to find inefficiency? My answer is that while few markets demonstrate great **structural inefficiency** today, many exhibit a great deal of **cyclical inefficiency** from time to time. Just five years ago, there were lots of things people wouldn't touch with a ten-foot pole, and as a result they offered absurdly high returns. Most of those opportunities are gone today, but I'm sure they'll be back the next time investors turn tail and run.

Markets will be permanently efficient when investors are permanently objective and unemotional. In other words, never. **Unless that unlikely day comes, skill <u>and</u> luck will both continue to play very important roles**.

January 16, 2014

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The aggregate performance of Oaktree's Distressed Debt Funds presented herein represents dollar-weighted internal rates of return ("IRR") on an absolute basis for the time period October 15, 1988 through September 30, 2013.

Prior to the formation of Oaktree in the second quarter of 1995, this record includes performance which the U.S. High Yield Bond and Distressed Debt teams achieved at Trust Company of the West.

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Oaktree U.S. High Yield Bond Strategy's primary benchmark, Citigroup High Yield Cash-Pay Capped Index: The Citigroup indices generally acquire only those bonds that have a non-investment grade rating by Moody's and S&P. The Citigroup indices include only cash-pay bonds. Prior to 1991, the Citigroup index was known as the Citigroup High Yield Index. The Citigroup Cash-Pay Capped Index is represented by the High Yield Cash-Pay Index beginning January 1, 1991 through June 30, 2002 and the High Yield Cash-Pay Capped Index thereafter, which limits the aggregate par per issuer to $5 billion. During 1998, the returns are that of the North American subset of the Citigroup Cash-Pay Index. Source: ©2013 Citigroup Index LLC. All rights reserved

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Memo to: Oaktree Clients

From: Howard Marks

Re: Dare to Be Great II

In September 2006, I wrote a memo entitled *Dare to Be Great*, with suggestions on how institutional investors might approach the goal of achieving superior investment results. I've had some additional thoughts on the matter since then, meaning it's time to return to it. Since fewer people were reading my memos in those days, I'm going to start off repeating a bit of its content and go on from there.

About a year ago, a sovereign wealth fund that's an Oaktree client asked me to speak to their leadership group on the subject of what makes for a superior investing organization. I welcomed the opportunity. The first thing you have to do, I told them, is formulate an explicit investing creed. What do you believe in? What principles will underpin your process? The investing team and the people who review their performance have to be in agreement on questions like these:

- Is the efficient market hypothesis relevant? Do efficient markets exist? Is it possible to "beat the market"? Which markets? To what extent?
- Will you emphasize risk control or return maximization as the primary route to success (or do you think it's possible to achieve both simultaneously)?
- Will you put your faith in macro forecasts and adjust your portfolio based on what they say?
- How do you think about risk? Is it volatility or the probability of permanent loss? Can it be predicted and quantified *a priori*? What's the best way to manage it?
- How reliably do you believe a disciplined process will produce the desired results? That is, how do you view the question of determinism versus randomness?
- **Most importantly for the purposes of this memo, how will you define success, and what risks will you take to achieve it? In short, in trying to be right, are you willing to bear the inescapable risk of being wrong?**

Passive investors, benchmark huggers and herd followers have a high probability of achieving average performance and little risk of falling far short. But in exchange for safety from being much below average, they surrender their chance of being much above average. All investors have to decide whether that's okay. And, if not, what they'll do about it.

The more I think about it, the more angles I see in the title *Dare to Be Great*. Who wouldn't dare to be great? No one. Everyone would love to have outstanding performance. **The real question is whether you dare to do the things that are necessary in order to be great. Are you willing to be different, and are you willing to be wrong? In order to have a chance at great results, you have to be open to being both.**

Dare to Be Different

Here's a line from *Dare to Be Great*: **"This just in: you can't take the same actions as everyone else and expect to outperform."** Simple, but still appropriate.

For years I've posed the following riddle: Suppose I hire you as a portfolio manager and we agree you will get no compensation next year if your return is in the bottom nine deciles of the investor universe but $10 million if you're in the top decile. **What's the first thing you have to do – the absolute prerequisite – in order to have a chance at the big money?** No one has ever answered it right.

The answer may not be obvious, but it's imperative: you have to assemble a portfolio that's different from those held by most other investors. If your portfolio looks like everyone else's, you may do well, or you may do poorly, *but you can't do different*. And being different is absolutely essential if you want a chance at being superior. In order to get into the top of the performance distribution, you have to escape from the crowd. There are many ways to try. They include being active in unusual market niches; buying things others haven't found, don't like or consider too risky to touch; avoiding market darlings that the crowd thinks can't lose; engaging in contrarian cycle timing; and concentrating heavily in a small number of things you think will deliver exceptional performance.

Dare to Be Great included the two-by-two matrix and paragraph below. Several people told me the matrix was helpful.

	Conventional Behavior	Unconventional Behavior
Favorable Outcomes	Average good results	Above-average results
Unfavorable Outcomes	Average bad results	Below-average results

> Of course it's not that easy and clear-cut, but I think that's the general situation. If your behavior and that of your managers is conventional, you're likely to get conventional results – either good or bad. **Only if your behavior is unconventional is your performance likely to be unconventional . . . and only if your judgments are superior is your performance likely to be above average.**

For those who define investment success as being "average or better," three of the four cells of the matrix represent satisfactory outcomes. But if you define success strictly as being superior, only one of the four will do, and it requires unconventional behavior. More from the 2006 memo:

> The bottom line on striving for superior performance has a lot to do with daring to be great. **Especially in terms of asset allocation, "can't lose" usually goes hand-in-hand with "can't win."** One of the investor's or the committee's first and most fundamental decisions has to be on the question of how far out the

> portfolio will venture. **How much emphasis should be put on diversifying, avoiding risk and ensuring against below-pack performance, and how much on sacrificing these things in the hope of doing better?**

In the memo I mentioned my favorite fortune cookie: "the cautious seldom err or write great poetry." Like the title *Dare to Be Great*, I find the fortune cookie thought-provoking. It can be taken as urging caution, since it reduces the likelihood of error. Or it can be taken as saying you should avoid caution, since it can keep you from doing great things. Or both. No right or wrong answer, but a choice . . . and hopefully a conscious one.

It Isn't Easy Being Different

In the 2006 memo, I borrowed two quotes from *Pioneering Portfolio Management* by David Swensen of Yale. They're my absolute favorites on the subject of institutional behavior. Here's the first:

> Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.

"Uncomfortably idiosyncratic" is a terrific phrase. There's a great deal of wisdom in those two words. What's idiosyncratic is rarely comfortable . . . and in order for something to be comfortable, it usually has to be conventional. The road to above average performance runs through unconventional, uncomfortable investing. Here's how I put it in 2006:

> Non-consensus ideas have to be lonely. **By definition, non-consensus ideas that are popular, widely held or intuitively obvious are an oxymoron.** Thus such ideas are uncomfortable; non-conformists don't enjoy the warmth that comes with being at the center of the herd. Further, unconventional ideas often appear imprudent. The popular definition of "prudent" – especially in the investment world – is often twisted into "what everyone does."

Most great investments begin in discomfort. The things most people feel good about – investments where the underlying premise is widely accepted, the recent performance has been positive and the outlook is rosy – are unlikely to be available at bargain prices. Rather, bargains are usually found among things that are controversial, that people are pessimistic about, and that have been performing badly of late.

But it isn't easy to do things that entail discomfort. It's no coincidence that distressed debt has been the source of many successful investments for Oaktree; there's no such thing as a distressed company that everyone reveres. In 1988, when Bruce Karsh and I organized our first fund to invest in the debt of companies seemingly at death's door, the very idea made it hard to raise money, and investing required conviction – on the clients' part and our own – that our analysis and approach would mitigate the risk. The same discomfort, however, is what caused distressed debt to be priced cheaper than it should have been, and thus the returns to be consistently high.

Dare to Be Wrong

"You have to give yourself a chance to fail." That's what Kenny "The Jet" Smith said on TV the other night during the NCAA college basketball tournament, talking about a star player who started out cold and as a result attempted too few shots in a game his team lost. It's a great way to make the point. Failure isn't anyone's goal, of course, but rather an inescapable potential consequence of trying to do really well.

Any attempt to compile superior investment results has to entail acceptance of the possibility of being wrong. The matrix on page two shows that since conventional behavior is sure to produce average performance, people who want to be above average can't expect to get there by engaging in conventional behavior. Their behavior has to be different. **And in the course of trying to be different and better, they have to bear the risk of being different and worse.** That truth is simply unarguable. There is no way to strive for the former that doesn't require bearing the risk of the latter.

The truth is, almost everything about superior investing is a two-edged sword:

- If you invest, you will lose money if the market declines.
- If you don't invest, you will miss out on gains if the market rises.

- Market timing will add value if it can be done right.
- Buy-and-hold will produce better results if timing can't be done right.

- Aggressiveness will help when the market rises but hurt when it falls.
- Defensiveness will help when the market falls but hurt when it rises.

- If you concentrate your portfolio, your mistakes will kill you.
- If you diversify, the payoff from your successes will be diminished.

- If you employ leverage, your successes will be magnified.
- If you employ leverage, your mistakes will be magnified.

Each of these pairings indicates symmetry. None of the tactics listed will add value if it's right but not subtract if it's wrong. Thus none of these tactics, in and of itself, can hold the secret to dependably above average investment performance.

There's only one thing in the investment world that isn't two-edged, and that's "alpha": superior insight or skill. Skill can help in both up markets and down markets. And by making it more likely that your decisions are right, superior skill can increase the expected benefit from concentration and leverage. But that kind of superior skill by definition is rare and elusive.

The goal in investing is asymmetry: to expose yourself to return in a way that doesn't expose you commensurately to risk, and to participate in gains when the market rises to a greater extent than you participate in losses when it falls. But that doesn't mean the avoidance of all losses is a reasonable objective. Take another look at the goal of asymmetry set out above: **it talks about achieving a preponderance of gain over loss, not avoiding all chance of loss.**

To succeed at any activity involving the pursuit of gain, we have to be able to withstand the possibility of loss. A goal of avoiding all losses can render success unachievable almost as readily as can the occurrence of too many losses. Here are three examples of "loss prevention strategies" that can lead to failure:

- I play tennis. But if when I start a match I promise myself that I won't commit a single double fault, I'll never be able to put enough "mustard" on my second serve to keep it from being easy for my opponent to put away.

- Likewise, coming out ahead at poker requires that I win a lot on my winning hands and lose less on my losers. But insisting that I'll never play anything but "the nuts" – the hand that can't possibly be beat – will keep me from playing lots of hands that have a good chance to win but aren't sure things.

- For a real-life example, Oaktree has always emphasized default avoidance as the route to outperformance in high yield bonds. Thus our default rate has consistently averaged just 1/3 of the universe default rate, and our risk-adjusted return has beaten the indices. But if we had insisted on – and designed compensation to demand – zero defaults, I'm sure we would have been too risk averse and our performance wouldn't have been as good. As my partner Sheldon Stone puts it, "If you don't have any defaults, you're taking too little risk."

When I first went to work at Citibank in 1968, they had a slogan that "scared money never wins." **It's important to play judiciously, to have more successes than failures, and to make more on your successes than you lose on your failures. But it's crippling to have to avoid all failures, and insisting on doing so can't be a winning strategy. It may guarantee you against losses, but it's likely to guarantee you against gains as well.** Here's some helpful wisdom on the subject from Wayne Gretzky, considered by many to be the greatest hockey player who ever lived: **"You miss 100% of the shots you don't take."**

There is no formulaic approach to investing that can be depended on to produce superior risk-adjusted returns. There can't be. In a relatively fair or "efficient" market – and the concerted efforts of investors to find underpriced assets tend to make most markets quite fair – asymmetry is reduced, and a formula that everyone can access can't possibly work.

As John Kenneth Galbraith said, "There is nothing reliable to be learned about making money. If there were, study would be intense and everyone with a positive IQ would be rich." If merely applying a formula that's available to everyone could be counted on to provide easy profits, where would those profits come from? Who would be the losers in those transactions? Why wouldn't those people study and apply the formula also?

Or as Charlie Munger told me, "It's not supposed to be easy. Anyone who finds it easy is stupid." In other words, anyone who thinks it can be easy to succeed at investing is being simplistic and superficial, and ignoring investing's complex and competitive nature.

Why should superior profits be available to the novice, the untutored or the lazy? Why should people be able to make above average returns without hard work and above average skill, and without knowing something most others don't know? And yet many individuals invest based on the belief that they can. (If they didn't believe that, wouldn't they index or, at a minimum, turn over the task to others?)

No, the solution can't lie in rigid tactics, publicly available formulas or loss-eliminating rules . . . or in complete risk avoidance. **Superior investment results can only stem from a better-than-average ability to figure out when risk-taking will lead to gain and when it will end in loss.** There is no alternative.

Dare to Look Wrong

This is really the bottom-line: not whether you dare to be different or to be wrong, but whether you dare to look wrong.

Most people understand and accept that in their effort to make correct investment decisions, they have to accept the risk of making mistakes. Few people expect to find a lot of sure things or achieve a perfect batting average.

While they accept the intellectual proposition that attempting to be a superior investor has to entail the risk of loss, many institutional investors – and especially those operating in a political or public arena – can find it unacceptable to look significantly wrong. Compensation cuts and even job loss can befall the institutional employee who's associated with too many mistakes.

As *Pensions & Investments* said on March 17 regarding a big West Coast bond manager currently in the news, whom I'll leave nameless:

> . . . asset owners are concerned that doing business with the firm could bring unwanted attention, possibly creating headline risk and/or job risk for them. . . .
>
> One [executive] at a large public pension fund said his fund recently allocated $100 million for emerging markets, its first allocation to the firm. He said he wouldn't do that today, given the current situation, because it could lead to second-guessing by his board and the local press.
>
> "If it doesn't work out, it looks like you don't know what you are doing," he said.

As an aside, let me say I find it perfectly logical that people should feel this way. Most "agents" – those who invest the money of others – will benefit little from bold decisions that work but will suffer greatly from bold decisions that fail. The possibility of receiving an "attaboy" for a few winners can't balance out the risk of being fired after a string of losers. Only someone who's irrational would conclude that the incentives favor boldness under these circumstances. Similarly, members of a non-profit organization's investment committee can reasonably conclude that bearing the risk of embarrassment in front of their peers that accompanies bold but unsuccessful decisions is unwarranted given their volunteer positions.

I'm convinced that for many institutional investment organizations the operative rule – intentional or unconscious – is this: "We would never buy so much of something that if it doesn't work, we'll look bad." For many agents and their organizations, the realities of life mandate such a rule. But people who follow this rule must understand that by definition it will keep them from buying enough of something that works for it to make much of a difference for the better.

In 1936, the economist John Maynard Keynes wrote in *The General Theory of Employment, Interest and Money*, "Worldly wisdom teaches that it is better *for reputation* to fail conventionally than to succeed unconventionally" [italics added]. For people who measure success in terms of dollars and cents, risk taking can pay off when gains on winners are netted out against losses on losers. **But if reputation or job retention is what counts, losers may be all that matter, since winners may be incapable of outweighing them. In that case, success may hinge entirely on the avoidance of unconventional behavior that's unsuccessful.**

Often the best way to choose between alternative courses of action is by figuring out which has the highest "expected value": the total value arrived at by multiplying each possible outcome by its probability of occurring and summing the results. As I learned from my first textbook at Wharton fifty years ago (*Decisions Under Uncertainty* by C. Jackson Grayson, Jr.), if one act has a higher expected value than another and ". . . if the decision maker is willing to regard the consequences of each act-event in purely *monetary* terms, then this would be the logical act to choose. Keeping in mind, however, that *only one event and its consequence will occur* (not the weighted average consequence)," agents may not be able to choose on the basis of expected value or the weighted average of all possible consequences. **If a given action has potential bad consequences that are absolutely unacceptable, the expected value of all of its consequences – both good and bad – can be irrelevant**.

Given the typical agent's asymmetrical payoff table, the rule for institutional investors underlined above is far from nonsensical. But if it is adopted, this should be done with awareness of the likely result: over-diversification. This goes all the way back to the beginning of this memo, and each organization's need to establish its creed. In this case, the following questions must be answered:

- In trying to achieve superior investment results, to what extent will we concentrate on investments, strategies and managers we think are outstanding? Will we do this despite the potential of our decisions to be wrong and bring embarrassment?

- Or will fear of error, embarrassment, criticism and unpleasant headlines make us diversify highly, emulate the benchmark portfolio and trade boldness for safety? Will we opt for low-cost, low-aspiration passive strategies?

In the course of the presentation described at the beginning of this memo, I pointed out to the sovereign wealth fund's managers that they had allocated close to a billion dollars to Oaktree's management over the preceding 15 years. Although that sounds like a lot of money, it actually amounts to only a few tenths of a percent of what the world guesses their assets to be. And given our funds' cycle of investing and divesting, that means they didn't have even a few tenths of a percent of their capital with us at any one time. Thus, despite our good performance, I think it's safe to say Oaktree couldn't have had a meaningful impact on the fund's overall results. Certainly one would associate this behavior with an extreme lack of risk tolerance and a high aversion to headline risk. I urged them to consider whether this reflects their real preference.

Lou Brock of the St. Louis Cardinals was one of baseball's best base stealers between 1966 and 1974. He's the source of a great quote: **"Show me a guy who's afraid to look bad, and I'll show you a guy you can beat every time."** What he meant (with apologies to readers who don't understand baseball) is that in order to prevent a great runner from stealing a base, a pitcher may have to throw over to the bag ten times in a row to hold him close, rather than pitch to the batter. But after a few such throws, a pitcher can look like a scaredy-cat and be booed. Pitchers who were afraid of those things were easy pickings for Lou Brock. Fear of looking bad ensured their failure.

Looking Right Can Be Harder Than Being Right

Fear of looking bad can be particularly debilitating to an investor, client or manager. This is because of how hard it is to consistently make correct investment decisions. Some of this comes from my last memo, on the role of luck.

- First, it's hard to consistently make decisions that correctly factor in all of the relevant facts and considerations (i.e., it's hard to be right).

- Second, it's far from certain that even "right" decisions will be successful, since every decision requires assumptions about what the future will look like, and even reasonable assumptions can be thwarted by the world's randomness. Thus many correct decisions will result in failure (i.e., it's hard to look right).

- Third, even well-founded decisions that eventually turn out to be right are unlikely to do so promptly. This is because not only are future events uncertain, their timing is particularly variable (i.e., it's impossible to look right on time).

This brings me to one of my three favorite adages: **"Being too far ahead of your time is indistinguishable from being wrong."** The fact that something's cheap doesn't mean it's going to appreciate tomorrow; it can languish in the bargain basement. And the fact that something's overpriced certainly doesn't mean it'll fall right away; bull markets can go on for years. As Lord Keynes observed, "the market can remain irrational longer than you can remain solvent."

Alan Greenspan warned of "irrational exuberance" in December 1996, but the stock market continued upward for more than three years. A brilliant manager I know who turned bearish around the same time had to wait until 2000 to be proved correct . . . during which time his investors withdrew much of their capital. He wasn't "wrong," just early. But that didn't make his experience any less painful.

Likewise, John Paulson made the most profitable trade in history by shorting mortgage securities in 2006. Many others entered into the same transactions, but too early. When the bets failed to work at first, the appearance of being on the wrong track ate into the investors' ability to stick with their decision, and they were forced to close out positions that would have been extremely profitable.

In order to be a superior investor, you need the strength to diverge from the herd, stand by your convictions, and maintain positions until events prove them right. Investors operating under harsh scrutiny and unstable working conditions can have a harder time doing this than others.

That brings me to the second quote I promised from Yale's David Swensen:

> . . . active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel.

Charlie Munger was right about it not being easy. **I'm convinced that everything that's important in investing is counterintuitive, and everything that's obvious is wrong.** Staying with counterintuitive, idiosyncratic positions can be extremely difficult for anyone, especially if they look wrong at first. So-called "institutional considerations" can make it doubly hard.

Investors who aspire to superior performance have to live with this reality. **Unconventional behavior is the only road to superior investment results, but it isn't for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes.** Thus each person has to assess whether he's temperamentally equipped to do these things and whether his circumstances – in terms of employers, clients and the impact of other people's opinions – will allow it . . . when the chips are down and the early going makes him look wrong, as it invariably will. Not everyone can answer these questions in the affirmative. It's those who believe they can that should take a chance on being great.

April 8, 2014

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Memo to: Oaktree Clients

From: Howard Marks

Re: Risk Revisited

In April I had good results with *Dare to Be Great II*, starting from the base established in an earlier memo (*Dare to Be Great,* September 2006) and adding new thoughts that had occurred to me in the intervening years. Also in 2006 I wrote *Risk,* my first memo devoted entirely to this key subject. My thinking continued to develop, causing me to dedicate three chapters to risk among the twenty in my book *The Most Important Thing*. This memo adds to what I've previously written on the topic.

What Risk Really Means

In the 2006 memo and in the book, I argued against the purported identity between volatility and risk. Volatility is the academic's choice for defining and measuring risk. I think this is the case largely because volatility is quantifiable and thus usable in the calculations and models of modern finance theory. In the book I called it "machinable," and there is no substitute for the purposes of the calculations.

However, while volatility is quantifiable and machinable – and can also be an indicator or symptom of riskiness and even a specific form of risk – I think it falls far short as "the" definition of investment risk. In thinking about risk, we want to identify the thing that investors worry about and thus demand compensation for bearing. I don't think most investors fear volatility. In fact, I've never heard anyone say, "The prospective return isn't high enough to warrant bearing all that volatility." **What they fear is the possibility of permanent loss.**

Permanent loss is very different from volatility or fluctuation. A downward fluctuation – which by definition is temporary – doesn't present a big problem if the investor is able to hold on and come out the other side. A permanent loss – from which there won't be a rebound – can occur for either of two reasons: (a) an otherwise-temporary dip is locked in when the investor sells during a downswing – whether because of a loss of conviction; requirements stemming from his timeframe; financial exigency; or emotional pressures, or (b) the investment itself is unable to recover for fundamental reasons. We can ride out volatility, but we never get a chance to undo a permanent loss.

Of course, the problem with defining risk as the possibility of permanent loss is that it lacks the very thing volatility offers: quantifiability. **The probability of loss is no more measurable than the probability of rain.** It can be modeled, and it can be estimated (and by experts pretty well), but it cannot be known.

In *Dare to Be Great II*, I described the time I spent advising a sovereign wealth fund about how to organize for the next thirty years. My presentation was built significantly around my conviction that risk can't be quantified *a priori*. Another of their advisors, a professor from a business school north of New York, insisted it can. This is something I prefer not to debate, especially with people who're sure they have the answer but haven't bet much money on it.

One of the things the professor was sure could be quantified was the maximum a portfolio could fall under adverse circumstances. But how can this be so if we don't know how adverse circumstances can be or how they will influence returns? We might say "the market probably won't fall more than x% as long as things aren't worse than y and z," but how can an absolute limit be specified? I wonder if the professor had anticipated that the S&P 500 could fall 57% in the global crisis.

While writing the original memo on risk in 2006, an important thought came to me for the first time. Forget about *a priori*; if you define risk as anything other than volatility, it can't be measured **even after the fact**. If you buy something for $10 and sell it a year later for $20, was it risky or not? The novice would say the profit proves it was safe, while the academic would say it was clearly risky, since the only way to make 100% in a year is by taking a lot of risk. I'd say it might have been a brilliant, safe investment that was sure to double <u>or</u> a risky dart throw that got lucky.

If you make an investment in 2012, you'll know in 2014 whether you lost money (and how much), but you won't know whether it was a risky investment – that is, what the probability of loss was at the time you made it. To continue the analogy, **it may rain tomorrow, or it may not, but nothing that happens tomorrow will tell you what the probability of rain was as of today. And the risk of rain is a very good analogue (although I'm sure not perfect) for the risk of loss.**

<u>The Unknowable Future</u>

It seems most people in the prediction business think the future is knowable, and all they have to do is be among the ones who know it. Alternatively, they may understand (consciously or unconsciously) that it's not knowable but believe they have to act as if it is in order to make a living as an economist or investment manager.

On the other hand, I'm solidly convinced the future isn't knowable. I side with John Kenneth Galbraith who said, "We have two classes of forecasters: Those who don't know – and those who don't know they don't know." There are several reasons for this inability to predict:

- We're well aware of many factors that can influence future events, such as governmental actions, individuals' spending decisions and changes in commodity prices. But these things are hard to predict, and I doubt anyone is capable of taking all of them into account at once. (People have suggested a parallel between this categorization and that of Donald Rumsfeld, who might have called these things "known unknowns": the things we know we don't know.)

- The future can also be influenced by events that aren't on anyone's radar today, such as calamities – natural or man-made – that can have great impact. The 9/11 attacks and the Fukushima disaster are two examples of things no one knew to think about. (These would be "unknown unknowns": the things we don't know we don't know.)

- There's far too much randomness at work in the world for future events to be predictable. As 2014 began, forecasters were sure the U.S. economy was gaining steam, but they were confounded when record cold weather caused GDP to fall 2.9% in the first quarter.

- And importantly, the connections between contributing influences and future outcomes are far too imprecise and variable for the results to be dependable.

That last point deserves discussion. Physics is a science, and for that reason an electrical engineer can guarantee you that if you flip a switch over here, a light will go on over there . . . every time. But there's good reason why economics is called "the dismal science," and in fact it isn't much of a science at all. In just the last few years we've had opportunity to see – contrary to nearly unanimous expectations – that interest rates near zero can fail to produce a strong rebound in GDP, and that a reduction of bond buying on the part of the Fed can fail to bring on higher interest rates. In economics and investments, because of the key role played by human behavior, you just can't say for sure that "if A, then B," as you can in real science. The weakness of the connection between cause and effect makes outcomes uncertain. In other words, it introduces risk.

Given the near-infinite number of factors that influence the future, the great deal of randomness present, and the weakness of the linkages, it's my solid belief that future events cannot be predicted with any consistency. In particular, predictions of important divergences from trends and norms can't be made with anything approaching the accuracy required for them to be helpful.

Coping with the Unknowable Future

Here's the essential conundrum: investing requires us to decide how to position a portfolio for future developments, but the future isn't knowable.

Taken to slightly greater detail:

- Investing requires the taking of positions that will be affected by future developments.
- The existence of negative possibilities surrounding those future developments presents risk.
- Intelligent investors pursue prospective returns that they think compensate them for bearing the risk of negative future developments.
- But future developments are unpredictable.

How can investors deal with the limitations on their ability to know the future? **The answer lies in the fact that not being able to know the future doesn't mean we can't deal with it.** It's one thing to know what's going to happen and something very different to have a feeling for the range of possible outcomes and the likelihood of each one happening. Saying we can't do the former doesn't mean we can't do the latter.

The information we're able to estimate – the list of events that might happen and how likely each one is – can be used to construct a probability distribution. **Key point number one in this memo is that the future should be viewed not as a fixed outcome that's destined to happen and capable of being predicted, but as a range of possibilities and, hopefully on the basis of insight into their respective likelihoods, as a probability distribution.**

Since the future isn't fixed and future events can't be predicted, risk cannot be quantified with any precision. I made the point in *Risk*, and I want to emphasize it here, that risk estimation has to be the province of experienced experts, and their work product will by necessity be subjective, imprecise, and more qualitative than quantitative (even if it's expressed in numbers).

There's little I believe in more than Albert Einstein's observation: **"Not everything that counts can be counted, and not everything that can be counted counts."** I'd rather have an order-of-magnitude approximation of risk from an expert than a precise figure from a highly educated statistician who knows less about the underlying investments. British philosopher and logician Carveth Read put it this way: "It is better to be vaguely right than exactly wrong."

By the way, in my personal life I tend to incorporate another of Einstein's comments: "I never think of the future – it comes soon enough." We can't take that approach as investors, however. We have to think about the future. We just shouldn't accord too much significance to our opinions.

We can't know what will happen. We can know something about the possible outcomes (and how likely they are). People who have more insight into these things than others are likely to make superior investors. As I said in the last paragraph of *The Most Important Thing*:

> Only investors with unusual insight can regularly divine the probability distribution that governs future events and sense when the potential returns compensate for the risks that lurk in the distribution's negative left-hand tail.

In other words, in order to achieve superior results, an investor must be able – with some regularity – to find asymmetries: instances when the upside potential exceeds the downside risk. That's what successful investing is all about.

Thinking in Terms of Diverse Outcomes

It's the indeterminate nature of future events that creates investment risk. **It goes without saying that if we knew everything that was going to happen, there wouldn't be any risk.**

The return on a stock will be a function of the relationship between the price today and the cash flows (income and sale proceeds) it will produce in the future. The future cash flows, in turn, will be a function of the fundamental performance of the company and the way its stock is priced given that performance. We invest on the basis of expectations regarding these things. It's tautological to say that if the company's earnings and the valuation of those earnings meet our targets, the return will be as expected. The risk in the investment therefore comes from the possibility that one or both will come in lower than we think.

To oversimplify, investors in a given company may have an expectation that if A happens, that'll make B happen, and if C and D also happen, then the result will be E. Factor A may be the pace at which a new product finds an audience. That will determine factor B, the growth of sales. If A is positive, B should be positive. Then if C (the cost of raw materials) is on target, earnings should grow as expected, and if D (investors' valuation of the earnings) also meets expectations, the result should be a rising share price, giving us the return we seek (E).

We may have a sense for the probability distributions governing future developments, and thus a feeling for the likely outcome regarding each of developments A through E. The problem is that for each of these, there can be lots of outcomes other than the ones we consider most likely. The possibility of less-good outcomes is the source of risk. **That leads me to my <u>second key point</u>, as expressed by Elroy Dimson, a professor at the London Business School: "Risk means more things can happen than will happen."** This brief, pithy sentence contains a great deal of wisdom.

Here's how I put it in *No Different This Time – The Lessons of '07* (December 2007):

> No ambiguity is evident when we view the past. Only the things that happened happened. **But that definiteness doesn't mean the process that creates outcomes is clear-cut and dependable. Many things could have happened in each case in the past, and the fact that only one did happen understates the variability that existed.** What I mean to say (inspired by Nicolas Nassim Taleb's *Fooled by Randomness*) is that

the history that took place is only one version of what it could have been. If you accept this, then the relevance of history to the future is much more limited than may appear to be the case.

People who rely heavily on forecasts seem to think there's only one possibility, meaning risk can be eliminated if they just figure out which one it is. The rest of us know many possibilities exist today, and it's not knowable which of them will occur. Further, things are subject to change, meaning there will be new possibilities tomorrow. **This uncertainty as to which of the possibilities will occur is the source of risk in investing.**

Even a Probability Distribution Isn't Enough

I've stressed the importance of viewing the future as a probability distribution rather than a single predetermined outcome. It's still essential to bear in mind **key point number three: Knowing the probabilities doesn't mean you know what's going to happen.** For example, every good backgammon player knows the probabilities governing throws of the dice. They know there are 36 possible outcomes, and that six of them add up to the number seven (1-6, 2-5, 3-4, 4-3, 5-2 and 6-1). Thus the chance of throwing a seven on any toss is 6 in 36, or 16.7%. There's absolutely no doubt about that. But even though we know the probability of each number, we're far from knowing what number will come up on a given roll.

Backgammon players are usually quite happy to make a move that will enable them to win unless the opponent rolls twelve, since only one combination of the dice will produce it: 6-6. The probability of rolling twelve is thus only 1 in 36, or less than 3%. But twelve does come up from time to time, and the people it turns into losers end up complaining about having done the "right" thing but lost. As my friend Bruce Newberg says, **"There's a big difference between probability and outcome."** Unlikely things happen – and likely things fail to happen – all the time. **Probabilities are likelihoods and very far from certainties.**

It's true with dice, and it's true in investing . . . and not a bad start toward conveying the essence of risk. Think again about the quote above from Elroy Dimson: "Risk means more things can happen than will happen." **I find it particularly helpful to invert Dimson's observation for key point number four: Even though many things can happen, only one will.**

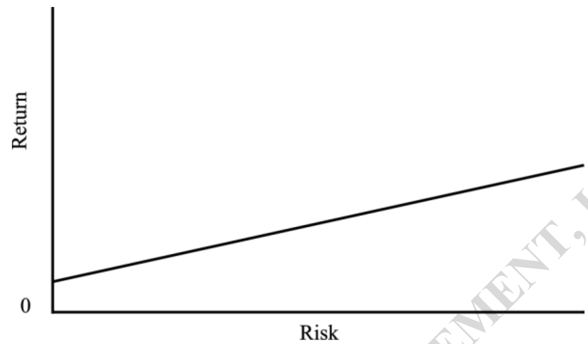
In *Dare to Be Great II*, I discussed the fact that economic decisions are usually best made on the basis of "expected value": you multiply each potential outcome by its probability, sum the results, and select the path with the highest total. But while expected value weights all of the possible outcomes on the basis of their likelihood, there may be some individual outcomes that absolutely cannot be tolerated. Even though many things can happen, only one will . . . and if something unacceptable can happen on the path with the highest expected value, we may not be able to choose on that basis. We may have to shun that path in order to avoid the extreme negative outcome. I always say I have no interest in being a skydiver who's successful 95% of the time.

Investment performance (like life in general) is a lot like choosing a lottery winner by pulling one ticket from a bowlful. The process through which the winning ticket is chosen can be influenced by physical processes, and also by randomness. But it never amounts to anything but one ticket picked from among many. **Superior investors have a better sense for the tickets in the bowl, and thus for whether it's worth buying a ticket in a lottery**. Lesser investors have less of a sense for the probability distribution and for whether the likelihood of winning the prize compensates for the risk that the cost of the ticket will be lost.

Risk and Return

Both in the 2006 memo on risk and in my book, I showed two graphics that together make clear the nature of investment risk. People have told me they're the best thing in the book, and since readers of this memo might have not seen the old one or read the book, I'm going to repeat them here.

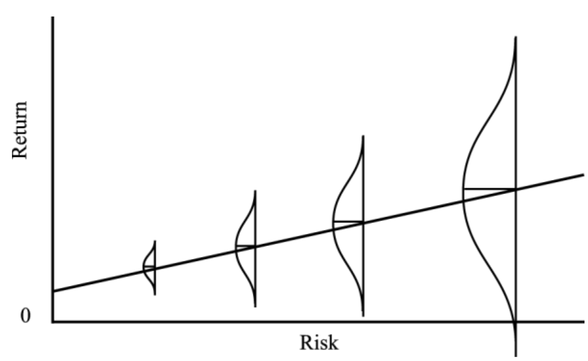
The first one below shows the relationship between risk and return as it is conventionally represented. The line slopes upward to the right, meaning the two are "positively correlated": as risk increases, return increases.



In both the old memo and the book, I went to great lengths to clarify what this is often – but erroneously – taken to mean. We hear it all the time: "Riskier investments produce higher returns" and "If you want to make more money, take more risk."

Both of these formulations are terrible. **In brief, if riskier investments could be counted on to produce higher returns, they wouldn't be riskier.** Misplaced reliance on the benefits of risk bearing has led investors to some very unpleasant surprises.

However, there's another, better way to describe this relationship: "Investments that seem riskier have to appear likely to deliver higher returns, or else people won't make them." This makes perfect sense. If the market is rational, the price of a seemingly risky asset will be set low enough that the reward for holding it seems adequate to compensate for the risk present. But note the word "appear." We're talking about investors' opinions regarding future return, not facts. Risky investments are – by definition – far from certain to deliver on their promise of high returns. For that reason, I think the graphic below does a much better job of portraying reality:



Here the underlying relationship between risk and return reflects the same positive general tendency as the first graphic, but the result of each investment is shown as a range of possibilities, not the single outcome suggested by the upward-sloping line. At each point along the horizontal risk axis, an investment's prospective return is shown as a bell-shaped probability distribution turned on its side.

The conclusions are obvious from inspection. As you move to the right, increasing the risk:

- the expected return increases (as with the traditional graphic),
- the range of possible outcomes becomes wider, and
- the less-good outcomes become worse.

This is the essence of investment risk. Riskier investments are ones where the investor is less secure regarding the eventual outcome and faces the possibility of faring worse than those who stick to safer investments, and even of losing money. These investments are undertaken because the expected return is higher. But things may happen other than that which is hoped for. Some of the possibilities are superior to the expected return, but others are decidedly unattractive.

The first graph's upward-sloping line indicates the underlying directionality of the risk/return relationship. But there's a lot more to consider than the fact that expected returns rise along with perceived risk, and in that regard the first graph is highly misleading. The second graph shows both the underlying trend <u>and</u> the increasing potential for actual returns to deviate from expectations. While the expected return rises along with risk, so does the probability of lower returns . . . and even of losses. **This way of looking at things reflects Professor Dimson's dictum that more than one thing can happen. That's reality in an unpredictable world.**

<u>The Many Forms of Risk</u>

The possibility of permanent loss may be the main risk in investing, but it's not the only risk. I can think of lots of other risks, many of which contribute to – or are components of – that main risk.

In the past, in addition to the risk of permanent loss, I've mentioned **the risk of falling short**. Some investors face return requirements in order to make necessary payouts, as in the case of pension funds, endowments and insurance companies. Others have more basic needs, like generating enough income to live on.

Some investors with needs – particularly those who live on their income, and especially in today's low-return environment – face a serious conundrum. **If they put their money into safe investments, their returns may be inadequate. But if they take on incremental risk in pursuit of a higher return, they face the possibility of a still-lower return, and perhaps of permanent diminution of their capital, rendering their subsequent income lower still.** There's no easy way to resolve this conundrum.

There are actually two possible causes of inadequate returns: (a) targeting a high return and being thwarted by negative events and (b) targeting a low return and achieving it. In other words, **investors face not one but two major risks: the risk of losing money and the risk of missing opportunities**. Either can be eliminated but not both. And leaning too far in order to avoid one can set you up to be victimized by the other.

Potential opportunity costs – the result of missing opportunities – usually aren't taken as seriously as real potential losses. But they do deserve attention. **Put another way, we have to consider the risk of not taking enough risk.**

These days, the fear of losing money seems to have receded (since the crisis is all of six years in the past), and the fear of missing opportunities is riding high, given the paltry returns available on safe, mundane investments. Thus a new risk has arisen: **FOMO risk, or the risk that comes from excessive fear of missing out**. It's important to worry about missing opportunities, since people who don't can invest too conservatively. But when that worry becomes excessive, FOMO can drive an investor to do things he shouldn't do and often doesn't understand, just because others are doing them: if he doesn't jump on the bandwagon, he may be left behind to live with envy.

Over the last three years, Oaktree's response to the paucity of return has been to develop a suite of five credit strategies that we hope will produce a 10% return, either net or gross (we can't claim to be more precise than that). I call them collectively the "ten percent solution," after a Sherlock Holmes story called *The Seven-Per-Cent Solution* (we aim to do better). Talking to clients about these strategies and helping them choose between them has required me to focus on their risks.

"Just a minute," you might say, "the ten-year Treasury is paying just 2½% and, as Jeremy Grantham says, the risk-free rate is also return-free. How, then, can you target returns in the vicinity of 10%?" The answer is that it can't be done without taking risk of some kind – and there are several candidates. I'll list below a few risks that we're consciously bearing in order to generate the returns our clients desire:

- Today's ultra-low interest rates imply low returns for anyone who invests in what are deemed safe fixed income instruments. So Oaktree's pursuit of attractive returns centers on accepting and managing **credit risk**, or the risk that a borrower will be unable to pay interest and repay principal as scheduled. Treasurys are assumed to be free of credit risk, and most high grade corporates are thought to be nearly so. **Thus those who intelligently accept incremental credit risk must do so with the expectation that the incremental return promised as compensation will prove sufficient**.

  Voluntarily accepting credit risk has been at the core of what Oaktree has done since its beginning in 1995 (and in fact since the seed was planted in 1978, when I initiated Citibank's high yield bond effort). But bearing credit risk will lead to attractive returns only if it's done well. Our activities are based on two beliefs: (a) that because the investing establishment is averse to credit risk, the incremental returns we receive for bearing it will compensate generously for the risk entailed and (b) that credit risk is manageable – i.e., unlike the general future, credit risk can be gauged by experts (like us) and reduced through credit selection. **It wouldn't make sense to voluntarily bear incremental credit risk if either of these two beliefs were lacking.**

- Another way to access attractive returns in today's low-rate environment is to bear **illiquidity risk** in order to take advantage of investors' normal dislike for illiquidity (superior returns often follow from investor aversion). Institutions that held a lot of illiquid assets suffered considerably in the crisis of 2008, when they couldn't sell them; thus many developed a strong aversion to them and in some cases imposed limitations on their representation in portfolios. Additionally, today the flow of retail money is playing a big part in driving up asset prices and driving down returns. Since retail money has a harder time making its way to illiquid assets, this has made the returns on the latter appear more attractive. It's noteworthy that there aren't mutual funds or ETFs for many of the things we're investing in.

- Some strategies introduce it voluntarily and some can't get away from it: **concentration risk**. "Everyone knows" diversification is a good thing, since it reduces the impact on results of a negative development. But some people eschew the safety that comes with diversification in favor of concentrating their investments in assets or with managers they expect to outperform.

And some investment strategies don't permit full diversification because of the limitations of their subject markets. Thus problems – if and when they occur – will be bigger *per se*.

- Especially given today's low interest rates, borrowing additional capital to enhance returns is another way to potentially increase returns. But doing so introduces **leverage risk**. Leverage adds to risk two ways. The first is magnification: people are attracted to leverage because it will magnify gains, but under unfavorable outcomes it will magnify losses instead.

  The second way in which leverage adds to risk stems from **funding risk**, one of the classic reasons for financial disaster. The stage is set when someone borrows short-term funds to make a long-term investment. If the funds have to be repaid at an awkward time – due to their maturity, a margin call, or some other reason – and the purchased assets can't be sold in a timely fashion (or can only be sold at a depressed price), an investment that might otherwise have been successful can be cut short and end in sorrow. Little or nothing may remain of the sale proceeds once the leverage has been repaid, in which case the investor's equity will be decimated. This is commonly called a meltdown. It's the primary reason for the saying, "Never forget the six-foot-tall man who drowned crossing the stream that was five feet deep on average." In times of crisis, success over the long run can become irrelevant.

- **When credit risk, illiquidity risk, concentration risk and leverage risk are borne intelligently, it is in the hope that the investor's skill will be sufficient to produce success. If so, the *potential* incremental returns that appear to be offered as risk compensation will turn into *realized* incremental returns** (per the graphic at the top of page 6). That's the only reason anyone would do these things.

  As the graphic at the bottom of page 6 illustrates, however, investing further out on the risk curve exposes one to a broader range of investment outcomes. In an efficient market, returns are tethered to the market average; in an inefficient market, they're not. **Inefficient markets offer the possibility that an investor will escape from the "gravitational pull" of the market's average return, but that can be either for the better or for the worse**. Superior investors – those with "alpha," or the personal skill needed to achieve outsized returns for a given level of risk – have scope to perform well above the mean return, while inferior investors can come out far below. So hiring an investment manager introduces **manager risk**: the risk of picking the wrong one. It's possible to pay management fees but get decisions that detract from results rather than add.

Some or all of the above risks are potentially entailed in our new credit strategies. Parsing them allows investors to choose among the strategies and accept the risks they're more comfortable with. The process can be quite informative.

Our oldest "new strategy" is Enhanced Income, where we use leverage to magnify the return from a portfolio of senior loans. We think senior loans have the lowest credit risk of anything Oaktree deals with, since they're senior-most among their issuer's debt and historically have produced very few credit losses. Further, they're among our most liquid assets, meaning we face relatively little illiquidity risk, and being active in a broad public market permits us to diversify, reducing concentration risk. Given the relatively high degree of safety stemming from these loans' seniority, returns aren't overly dependent on the presence of alpha, meaning Enhanced Income entails less manager risk than some other strategies. But to have a chance at the healthy return we're pursuing in Enhanced Income requires us to take some risk, and what we're left with is leverage risk. The 3-to-1 leverage in Enhanced Income Fund II will magnify the negative impact of any credit losses (of course we hope there won't be many). However, we're not worried about a meltdown, since the current environment allows us to avoid funding risk; we can (a) borrow for a term that exceeds the duration of the underlying investments and (b) do so without the threat of margin calls related to price declines.

Strategic Credit, Mezzanine Finance, European Private Debt and Real Estate Debt are the other four components of our "ten percent solution."

- All four entail some degree of credit risk, illiquidity risk (they all invest heavily or entirely in private debt) and concentration risk (as their market niches offer only a modest number of investment opportunities, and securing them in today's competitive environment is a challenge).

- The Real Estate Debt Fund can only lever up to 1-to-1, and the other three borrow only small amounts and for short-term purposes, so none of them entails significant leverage risk.

- However, in order to succeed they'll all require a high level of skill from their managers in identifying return prospects and keeping risk under control. Thus they all entail manager risk. Our response is to entrust these portfolios only to managers who've been with us for years.

It's reasonable – essential, really – to study the risk entailed in every investment and accept the amounts and types of risk that you're comfortable with (assuming this can be discerned). It's not reasonable to expect highly superior returns without bearing some incremental risk.

I touched above on concentration risk, but we should also think about the flip side: **the risk of over-diversification**. If you have just a few holdings in a portfolio, or if an institution employs just a few managers, one bad decision can do significant damage to results. But if you have a very large number of holdings or managers, no one of them can have much of a positive impact on performance. Nobody invests in just the one stock or manager they expect to perform best, but as the number of positions is expanded, the standards for inclusion may decline. Peter Lynch coined the term "diworstification" to describe the process through which lesser investments are added to portfolios, making the potential risk-adjusted return worse.

While I don't think volatility and risk are synonymous, there's no doubt that **volatility does present risk**. If circumstances cause you to sell a volatile investment at the wrong time, you might turn a downward fluctuation into a permanent loss. Moreover, even in the absence of a need for liquidity, volatility can prey on investors' emotions, reducing the probability they'll do the right thing. **And in the short run, it can be very hard to differentiate between a downward fluctuation and a permanent loss.** Often this can really be done only in retrospect. Thus it's clear that a professional investor may have to bear consequences for a temporary downward fluctuation simply because of its resemblance to a permanent loss. When you're under pressure, the distinction between "volatility" and "loss" can seem only semantic. Volatility is not "the" definition of investment risk, as I said earlier, but it isn't irrelevant.

One example of a risk connected with volatility – or the deviation of price from what might be intrinsic value – is **basis risk**. Arbitrageurs customarily set up positions where they're long one asset and short a related asset. The two assets are expected to move roughly in parallel, except that the one that's slightly cheaper should make more money for the investor in the long run than the other loses, producing a small net gain with little risk. Because these trades are considered so low in risk, they're often levered up to the sky. But sometimes the prices of the two assets diverge to an unexpected extent, and the equity invested in the trade evaporates. That unexpected divergence is basis risk, and it's what happened to Long-Term Capital Management in 1998, one of the most famous meltdowns of all time. As Long-Term's chairman John Meriwether said at the time, "the Fund added to its positions in anticipation of convergence, yet . . . the trades diverged dramatically." This benign-sounding explanation was behind a collapse some thought capable of bringing down the global financial system.

Long-Term's failure was also attributable to **model risk**. Decisions can be turned over to quants or financial engineers who either (a) conclude wrongly that an unsystematic process can be modeled or (b) employ the wrong model. During the financial crisis, models often assumed that events would occur according to a "normal distribution," but extreme "tail events" occurred much more often than the normal distribution says they will. **Not only can extreme events exceed a model's assumptions, but excessive belief in a model's efficacy can induce people to take risks they would never take on the basis of qualitative judgment**. They're often disappointed to find they had put too much faith in a statistical sure thing.

Model risk can arise from **black swan risk**, for which I borrow the title of Nassim Nicholas Taleb's popular second book. People tend to confuse "never been seen" with "impossible," and the consequences can be dire when something occurs for the first time. That's part of the reason why people lost so much in highly levered subprime mortgage securities. The fact that a nationwide spate of mortgage defaults **hadn't happened** convinced investors that it **couldn't happen**, and their certainty caused them to take actions so imprudent that it **had to happen**.

As long as we're on the subject of things going wrong, we should touch on the subject of **career risk**. As I mentioned in *Dare to Be Great II*, "agents" who manage money for others can be penalized for investments that look like losers (that is, for both permanent losses and temporary downward fluctuations). Either of these unfortunate experiences can result in **headline risk** if the resulting losses are big enough to make it into the media, and some careers can't withstand headline risk. Investors who lack the potential to share commensurately in investment successes face a reward asymmetry that can force them toward the safe end of the risk/return curve. They are likely to think more about the risk of losing money than about the risk of missing opportunities. Thus their portfolios may lean too far toward controlling risk and avoiding embarrassment (and they may not take enough chances to generate returns). There are consequences for these investors, as well as for those who employ them.

Event risk is another risk to worry about, something that was created by bond issuers about twenty years ago. Since corporate directors have a fiduciary responsibility to stockholders but not to bondholders, some think they can (and perhaps should) do anything that's not explicitly prohibited to transfer value from bondholders to stockholders. Bondholders need covenants to shield them from this kind of pro-active plundering, but at times like today it can be hard to obtain strong protective covenants.

There are many ways for an investment to be unsuccessful. The two main ones are **fundamental risk** (relating to how a company or asset performs in the real world) and **valuation risk** (relating to how the market prices that performance). For years investors, fiduciaries and rule-makers acted on the belief that it's safe to buy high-quality assets and risky to buy low-quality assets. But between 1968 and 1973, many investors in the "Nifty Fifty" (the stocks of the fifty fastest-growing and best companies in America) lost 80-90% of their money. Attitudes have evolved since then, and today there's less of an assumption that high quality prevents fundamental risk, and much less preoccupation with quality for its own sake.

On the other hand, investors are more sensitive to the pivotal role played by price. **At bottom, the riskiest thing is overpaying for an asset (regardless of its quality), and the best way to reduce risk is by paying a price that's irrationally low (ditto).** A low price provides a "margin of safety," and that's what risk-controlled investing is all about. **Valuation risk should be easily combatted, since it's largely within the investor's control. All you have to do is refuse to buy if the price is too high given the fundamentals.** "Who wouldn't do that?" you might ask. Just think about the people who bought into the tech bubble.

Fundamental risk and valuation risk bear on the risk of losing money in an individual security or asset, but that's far from the whole story. **Correlation** is the essential additional piece of the puzzle.

Correlation is the degree to which an asset's price will move in sympathy with the movements of others. **The higher the correlation among its components, all other things being equal, the less effective diversification a portfolio has, and the more exposed it is to untoward developments.**

An asset doesn't have "a correlation." Rather, it has a different correlation with every other asset. A bond has a certain correlation with a stock. One stock has a certain correlation with another stock (and a different correlation with a third). Stocks of one type (such as emerging market, high-tech or large-cap) are likely to be highly correlated with others within their category, but they may be either high or low in correlation with those in other categories. **Bottom line: it's hard to estimate the riskiness of a given asset, but many times harder to estimate its correlation with all the other assets in a portfolio, and thus the impact on performance of adding it to the portfolio.** This is a real art.

Fixed income investors are directly exposed to another form of risk: **interest rate risk**. Higher interest rates mean lower bond prices – that relationship is absolute. The impact of changes in interest rates on asset classes other than fixed income is less direct and less obvious, but it also pervades the markets. Note that stocks usually go down when the Fed says the economy is performing strongly. Why? The thinking is that stronger economy = higher interest rates = more competition for stocks from bonds = lower stock valuations. Or it might be stronger economy = higher interest rates = reduced stimulus = weaker economy.

One of the reasons for increases in interest rates relates to **purchasing power risk**. Investors in securities (and especially long-term bonds) are exposed to the risk that if inflation rises, the amount they receive in the future will buy less than it could today. This causes investors to insist on higher interest rates and higher prospective returns to protect them against the loss of purchasing power. The result is lower prices.

Finally, I want to mention a new concept I hear about once in a while: **upside risk**. Forecasters are sometimes heard to say "the risk is on the upside." At first this doesn't seem to have much legitimacy, but it can be about the possibility that the economy may catch fire and do better than expected, earnings may come in above consensus, or the stock market may appreciate more than people think. Since these things are positives, there's risk in being underexposed to them.

*   *   *

To move to the biggest of big pictures, I want to make a few over-arching comments about risk.

The first is that risk is counterintuitive.

- The riskiest thing in the world is the widespread belief that there's no risk.
- Fear that the market is risky (and the prudent investor behavior that results) can render it quite safe.
- As an asset declines in price, making people view it as riskier, it becomes less risky (all else being equal).
- As an asset appreciates, causing people to think more highly of it, it becomes riskier.
- Holding only "safe" assets of one type can render a portfolio under-diversified and make it vulnerable to a single shock.
- Adding a few "risky" assets to a portfolio of safe assets can make it safer by increasing its diversification. Pointing this out was one of Professor William Sharpe's great contributions.

The second is that risk aversion is the thing that keeps markets safe and sane.

- When investors are risk-conscious, they will demand generous risk premiums to compensate them for bearing risk. Thus the risk/return line will have a steep slope (the unit increase in prospective return per unit increase in perceived risk will be large) and the market should reward risk-bearing as theory asserts.
- But when people forget to be risk-conscious and fail to require compensation for bearing risk, they'll make risky investments even if risk premiums are skimpy. The slope of the line will be gradual, and risk taking is likely to eventually be penalized, not rewarded.
- When risk aversion is running high, investors will perform extensive due diligence, make conservative assumptions, apply skepticism and deny capital to risky schemes.
- But when risk tolerance is widespread instead, these things will fall by the wayside and deals will be done that set the scene for subsequent losses.

Simply put, risk is low when risk aversion and risk consciousness are high, and high when they're low.

The third is that risk is often hidden and thus deceptive. Loss occurs when risk – the possibility of loss – collides with negative events. Thus the riskiness of an investment becomes apparent only when it is tested in a negative environment. It can be risky but not show losses as long as the environment remains salutary. The fact that an investment is susceptible to a serious negative development that will occur only infrequently – what I call "the improbable disaster" – can make it appear safer than it really is. Thus after several years of a benign environment, a risky investment can easily pass for safe. That's why Warren Buffett famously said, ". . . you only find out who's swimming naked when the tide goes out."

Assembling a portfolio that incorporates risk control as well as the potential for gains is a great accomplishment. But it's a hidden accomplishment most of the time, since risk only turns into loss occasionally . . . when the tide goes out.

The fourth is that risk is multi-faceted and hard to deal with. In this memo I've mentioned 24 different forms of risk: the risk of losing money, the risk of falling short, the risk of missing opportunities, FOMO risk, credit risk, illiquidity risk, concentration risk, leverage risk, funding risk, manager risk, over-diversification risk, risk associated with volatility, basis risk, model risk, black swan risk, career risk, headline risk, event risk, fundamental risk, valuation risk, correlation risk, interest rate risk, purchasing power risk, and upside risk. And I'm sure I've omitted some. Many times these risks are overlapping, contrasting and hard to manage simultaneously. For example:

- Efforts to reduce the risk of losing money invariably increase the risk of missing out.
- Efforts to reduce fundamental risk by buying higher-quality assets often increase valuation risk, given that higher-quality assets often sell at elevated valuation metrics.

At bottom, it's the inability to arrive at a single formula that simultaneously minimizes all the risks that makes investing the fascinating and challenging pursuit it is.

The fifth is that the task of managing risk shouldn't be left to designated risk managers. I'm convinced outsiders to the fundamental investment process can't know enough about the subject assets to make appropriate decisions regarding each one. All they can do is apply statistical models and norms. But those models may be the wrong ones for the underlying assets – or just plain faulty – and there's little evidence that they add value. In particular, risk managers can try to estimate correlation and tell you how things will behave when combined in a portfolio. But they can fail to adequately anticipate the "fault lines" that run through portfolios. And anyway, as the old saying goes, "in times of crisis all correlations go to one" and everything collapses in unison.

"Value at Risk" was supposed to tell the banks how much they could lose on a very bad day. During the crisis, however, VaR was often shown to have understated the risk, since the assumptions hadn't been harsh enough. Given the fact that risk managers are required at banks and *de rigueur* elsewhere, I think more money was spent on risk management in the early 2000s than in the rest of history combined . . . and yet we experienced the worst financial crisis in 80 years. Investors can calculate risk metrics like VaR and Sharpe ratios (we use them at Oaktree; they're the best tools we have), but they shouldn't put too much faith in them. **The bottom line for me is that risk management should be the responsibility of every participant in the investment process, applying experience, judgment and knowledge of the underlying investments.**

The sixth is that while risk should be dealt with constantly, investors are often tempted to do so only sporadically. Since risk only turns into loss when bad things happen, this can cause investors to apply risk control only when the future seems ominous. At other times they may opt to pile on risk in the expectation that good things lie ahead. But since we can't predict the future, we never really know when risk control will be needed. Risk control is unnecessary in times when losses don't occur, but that doesn't mean it's wrong to have it. The best analogy is to fire insurance: do you consider it a mistake to have paid the premium in a year in which your house didn't burn down?

Taken together these six observations convince me that Charlie Munger's trenchant comment on investing in general – **"It's not supposed to be easy. Anyone who finds it easy is stupid." –** is profoundly applicable to risk management. Effective risk management requires deep insight and a deft touch. It has to be based on a superior understanding of the probability distributions that will govern future events. Those who would achieve it have to have a good sense for what the crucial moving parts are, what will influence them, what outcomes are possible, and how likely each one is. **<u>Following on with Charlie's idea, thinking risk control is easy is perhaps the greatest trap in investing, since excessive confidence that they have risk under control can make investors do very risky things</u>.**

Thus the key prerequisites for risk control also include humility, lack of hubris, and knowing what you don't know. No one ever got into trouble for confessing a lack of prescience, being highly risk-conscious, and even investing scared. Risk control may restrain results during a rebound from crisis conditions or extreme under-valuations, when those who take the most risk generally make the most money. But it will also extend an investment career and increase the likelihood of long-term success. **That's why Oaktree was built on the belief that risk control is "the most important thing."**

Lastly while dealing in generalities, I want to point out that whereas risk control is indispensable, risk avoidance isn't an appropriate goal. The reason is simple: risk avoidance usually goes hand-in-hand with return avoidance. While you shouldn't expect to make money just for bearing risk, you also shouldn't expect to make money without bearing risk.

* * *

At present I consider risk control more important than usual. To put it briefly:

- Today's ultra-low interest rates have brought the prospective returns on money market instruments, Treasurys and high grade bonds to nearly zero.
- This has caused money to flood into riskier assets in search of higher returns.
- This, in turn, has caused some investors to drop their usual caution and engage in aggressive tactics.
- And this, finally, has caused standards in the capital markets to deteriorate, making it easy for issuers to place risky securities and – consequently – hard for investors to buy safe ones.

Warren Buffett put it best, and I regularly return to his statement on the subject:

> . . . the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.

While investor behavior hasn't sunk to the depths seen just before the crisis (and, in my opinion, that contributed greatly to it), **in many ways it has entered the zone of imprudence**. To borrow a metaphor from Chuck Prince, Citigroup's CEO from 2003 to 2007, anyone who's totally unwilling to dance to today's fast-paced music can find it challenging to put money to work.

It's the job of investors to strike a proper balance between offense and defense, and between worrying about losing money and worrying about missing opportunity. **Today I feel it's important to pay more attention to loss prevention than to the pursuit of gain**. For the last three years Oaktree's mantra has been "move forward, but with caution." At this time, in reiterating that mantra, I would increase the emphasis on those last three words: "but with caution."

Economic and company fundamentals in the U.S. are fine today, and asset prices – while full – don't seem to be at bubble levels. But when undemanding capital markets and a low level of risk aversion combine to encourage investors to engage in risky practices, something usually goes wrong eventually. **Although I have no idea what could make the day of reckoning come sooner rather than later, I don't think it's too early to take today's carefree market conditions into consideration. What I do know is that those conditions are creating a degree of risk for which there is no commensurate risk premium.** We have to behave accordingly.

September 3, 2014

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Lessons of Oil

I want to provide a memo on this topic before I – and hopefully many of my readers – head out for year-end holidays. I'll be writing not with regard to the right price for oil – about which I certainly have no unique insight – but rather, as indicated by the title, about what we can learn from recent experience.

- Despite my protestations that I don't know any more than others about future macro events – and thus that my opinions on the macro are unlikely to help anyone achieve above average performance – people insist on asking me about the future. Over the last eighteen months (since Ben Bernanke's initial mention that we were likely to see some "tapering" of bond buying), most of the macro questions I've gotten have been about whether the Fed would move to increase interest rates, and particularly when. These are the questions that have been on everyone's mind.

  Since mid-2013, the near-unanimous consensus (with credit to DoubleLine's Jeffrey Gundlach for vocally departing from it) has been that rates would rise. And, of course, the yield on the 10-year Treasury has fallen from roughly 3% at that time to 2.2% today. This year many investing institutions are underperforming the passive benchmarks and attributing part of the shortfall to the fact that their fixed income holdings have been too short in duration to allow them to benefit from the decline of interest rates. **While this has nothing to do with oil, I mention it to provide a reminder that what "everyone knows" is usually unhelpful at best and wrong at worst**.

- **Not only did the investing herd have the outlook for rates wrong, but it was uniformly inquiring about the wrong thing**. In short, while everyone was asking whether the rate rise would begin in December 2014 or April 2015 (or might it be June?) – in response to which I consistently asked why the answer matters and how it might alter investment decisions – few people I know were talking about whether the price of oil was in for a significant change.

  Back in 2007, in *It's All Good*, I provided a brief list of some possibilities for which I thought stock prices weren't giving enough allowance. I included "$100 oil" (since a barrel was selling in the $70s at the time) and ended with "the things I haven't thought of." I suggested that it's usually that last category – the things that haven't been considered – we should worry about most. **Asset prices are often set to allow for the risks people are aware of. It's the ones they haven't thought of that can knock the market for a loop.**

- In my book *The Most Important Thing*, I mentioned something I call "the failure of imagination." I defined it as "either being unable to conceive of the full range of possible outcomes or not understanding the consequences of the more extreme occurrences." Both aspects of the definition apply here.

  The usual starting point for forecasting something is its current level. Most forecasts extrapolate, perhaps making modest adjustments up or down. In other words, most forecasting is done incrementally, and few predictors contemplate order-of-magnitude changes. Thus I imagine that with Brent crude around $110 six months ago, the bulls were probably predicting $115 or $120 and the bears $105 or $100. **Forecasters usually stick too closely to the current level, and on**

those rare occasions when they call for change, they often underestimate the potential magnitude. Very few people predicted oil would decline significantly, and fewer still mentioned the possibility that we would see $60 within six months.

For several decades, Byron Wien of Blackstone (and formerly of Morgan Stanley, where he authored widely read strategy pieces) has organized summer lunches in the Hamptons for "serious," prominent investors. At the conclusion of the 2014 series in August, he reported as follows with regard to the consensus of the participants:

> Most believed that the price of oil would remain around present levels. Several trillion dollars have been invested in drilling over the last few years and yet production is flat because Nigeria, Iraq and Libya are producing less. The U.S. and Europe are reducing consumption, but that is being more than offset by increasing demand from the developing world, particularly China. Five years from now the price of Brent is likely to be closer to $120 because of emerging market demand.

I don't mean to pick on Byron or his luncheon guests. In fact, I think the sentiments he reported were highly representative of most investors' thinking at the time.

As a side note, it's interesting to observe that growth in China already was widely understood to be slowing, but perhaps that recognition never made its way into the views on oil of those present at Byron's lunches. **This is an example of how hard it can be to appropriately factor all of the relevant considerations into complex real-world analysis**.

- Turning to the second aspect of "the failure of imagination" and going beyond the inability of most people to imagine extreme outcomes, the current situation with oil also illustrates how difficult it is to understand the full range of potential ramifications. **Most people easily grasp the immediate impact of developments, but few understand the "second-order" consequences . . . as well as the third and fourth**. When these latter factors come to be reflected in asset prices, this is often referred to as "contagion." Everyone knew in 2007 that the sub-prime crisis would affect mortgage-backed securities and homebuilders, but it took until 2008 for them to worry equally about banks and the rest of the economy.

  The following list is designed to illustrate the wide range of possible implications of an oil price decline, both direct consequences and their ramifications:

  - Lower prices mean reduced revenue for oil-producing nations such as Saudi Arabia, Russia and Brunei, causing GDP to contract and budget deficits to rise.
  - There's a drop in the amounts sent abroad to purchase oil by oil-importing nations like the U.S., China, Japan and the United Kingdom.
  - Earnings decline at oil exploration and production companies but rise for airlines whose fuel costs decline.
  - Investment in oil drilling declines, causing the earnings of oil services companies to shrink, along with employment in the industry.
  - Consumers have more money to spend on things other than energy, benefitting consumer goods companies and retailers.
  - Cheaper gasoline causes driving to increase, bringing gains for the lodging and restaurant industries.

- With the cost of driving lower, people buy bigger cars – perhaps sooner than they otherwise would have – benefitting the auto companies. They also keep buying gasoline-powered cars, slowing the trend toward alternatives, to the benefit of the oil industry.
- Likewise, increased travel stimulates airlines to order more planes – a plus for the aerospace companies – but at the same time the incentives decline to replace older planes with fuel-efficient ones. (This is a good example of the analytical challenge: is the net impact on airplane orders positive or negative?)
- By causing the demand for oil services to decline, reduced drilling leads the service companies to bid lower for business. This improves the economics of drilling and thus helps the oil companies.
- Ultimately, if things get bad enough for oil companies and oil service companies, banks and other lenders can be affected by their holdings of bad loans.

- **Further, it's hard for most people to understand the self-correcting aspects of economic events**.

    - A decline in the price of gasoline induces people to drive more, increasing the demand for oil.
    - A decline in the price of oil negatively impacts the economics of drilling, reducing additions to supply.
    - A decline in the price of oil causes producers to cut production and leave oil in the ground to be sold later at higher prices.

  In all these ways, lower prices either increase the demand for oil or reduce the supply, causing the price of oil to rise (all else being equal). In other words, lower oil prices – in and of themselves – eventually make for higher oil prices. **This illustrates the dynamic nature of economics**.

- Finally, in addition to the logical but often hard-to-anticipate second-order consequences or knock-on effects, negative developments often morph in illogical ways. Thus, in response to cascading oil prices, "I'm going to sell out of emerging markets that rely on oil exports" can turn into "I'm going to sell out of all emerging markets," even oil importers that are aided by cheaper oil.

  In part the emotional reaction to negative developments is the product of surprise and disillusionment. Part of this may stem from investors' inability to understand the "fault lines" that run through their portfolios. Investors knew changes in oil prices would affect oil companies, oil services companies, airlines and autos. But they may not have anticipated the effects on currencies, emerging markets and below-investment grade credit broadly. Among other things, they rarely understand that capital withdrawals and the resulting need for liquidity can lead to urgent selling of assets that are completely unrelated to oil. **People often fail to perceive that these fault lines exist, and that contagion can reach as far as it does. And then, when that happens, investors turn out to be unprepared, both intellectually and emotionally.**

  A grain of truth underlies most big up and down moves in asset prices. Not just "oil's in oversupply" today, but also "the Internet will change the world" and "mortgage debt has historically been safe." Psychology and herd behavior make prices move too far in response to those underlying grains of truth, causing bubbles and crashes, but also leading to opportunities to make great sales of overpriced assets on the rise and bargain purchases in the subsequent fall. **If you think markets are logical and investors are objective and unemotional, you're in for a lot of surprises.** In tough times, investors often fail to apply discipline and discernment;

psychology takes over from fundamentals; and "all correlations go to one," as things that should be distinguished from each other aren't.

- To give you an idea about how events in one part of the economy can have repercussions in other economic and market segments, I'll quote from some of the analyses I've received this week from Oaktree investment professionals:

  - Energy is a very significant part of the high yield bond market. In fact, it is the largest sector today (having taken over from media/telecom, which has traditionally been the largest). This is the case because the exploration industry is highly capital-intensive, and the high yield bond market has been the easiest place to raise capital. The knock-on effects of a precipitous fall in bond prices in the biggest sector in the high yield bond market are potentially substantial: outflows of capital, and mutual fund and ETF selling. It would be great for opportunistic buyers if the selling gets to sectors that are fundamentally in fine shape . . . because a number of them are. And, in fact, low oil prices can even make them better.

  - An imperfect analogy might be instructive: capital market conditions for energy-related assets today are not unlike what we saw in the telecom sector in 2002. As in telecom, you've had the confluence of really cheap financing, innovative technology, and prices for the product that were quite stable for a good while. [To this list of contributing factors, I would add the not-uncommon myth of perpetually escalating demand for a product.] These conditions resulted in the creation of an oversupply of capacity in oil, leading to a downdraft. It's historically unprecedented for the energy sector to witness this type of market downturn while the rest of the economy is operating normally. Like in 2002, we could see a scenario where the effects of this sector dislocation spread wider in a general "contagion."

  - Selling has been reasonably indiscriminate and panicky (much like telecom in 2002) as managers have realized (too late) how overexposed they are to the energy sector. Trading desks do not have sufficient capital to make markets, and thus price swings have been predictably volatile. The oil selloff has also caused deterioration in emerging market fundamentals and may force spreads to gap out there. This ultimately may create a feedback loop that results in contagion to high yield bonds generally.

- Over the last year or so, while continuing to feel that U.S. economic growth will be slow and unsteady in the next year or two, I came to the conclusion that any surprises were most likely to be to the upside. And my best candidate for a favorable development has been the possibility that the U.S. would sharply increase its production of oil and gas. This would make the U.S. oil-independent, making it a net exporter of oil and giving it a cost advantage in energy – based on cheap production from fracking and shale – and thus a cost advantage in manufacturing. Now, the availability of cheap oil all around the world threatens those advantages. So much for macro forecasting!

- There's a great deal to be said about the price change itself. A well-known quote from economist Rudiger Dornbusch goes as follows: **"In economics things take longer to happen than you think they will, and then they happen faster than you thought they could."** I don't know if many people were thinking about whether the price of oil would change, but the decline of 40%-plus must have happened much faster than anyone thought possible.

- "Everyone knows" (now!) that the demand for oil turned soft (due to sluggish economic growth, increased fuel efficiency and the emergence of alternatives) at the same time that the supply was increasing (as new sources came on stream). Equally, everyone knows that lower demand and higher supply imply lower prices. Yet it seems few people recognized the ability of these changes to alter the price of oil. A good part of this probably resulted from belief in the ability of OPEC (meaning largely the Saudis) to support prices by limiting production.

A price that's kept aloft by the operation of a cartel is, by definition, higher than it would be based on supply and demand alone. Maybe the thing that matters is how far the cartelized price is from the free-market price; the bigger the gap, the shorter the period for which the cartel will be able to maintain control. Initially a cartel or a few of its members may be willing to bear pain to support the price by limiting production even while others produce full-out. But there may come a time when the pain becomes unacceptable and the price supporters quit. **The key lesson here may be that cartels and other anti-market mechanisms can't hold forever.** As Herb Stein said, "If something cannot go on forever, it will stop." Maybe we've just proved that this extends to the effectiveness of cartels.

- Anyway, on the base of 93 million barrels a day of world oil use, some softness in consumption combined with an increase in production to cut the price by more than 40% in just a few months. **What this proves – about most things – is that to Dornbusch's quote above we should append the words ". . . and they go much further than you thought they could."**

  The extent of the price decline seems much greater than the changes in supply and demand would call for. Perhaps to understand it you have to factor in (a) Saudi Arabia's ceasing to balance supply and demand in the oil market by cutting production, after having done so for many years, and (b) a large contribution to the decline on the part of psychology. (In the "conspiracy theory" department, consider the rumor that Saudi Arabia is allowing or abetting the price drop in order to either punish Iran, Iraq and ISIL; put the U.S. shale oil industry out of business; or discipline the more profligate members of OPEC . . . take your pick.)

  The price of oil thus may have gone from too high (supported by OPEC and by Saudi Arabia in particular) to too low (depressed by negative psychology). It seems to me with regard to the latter that the price fell too far for some market participants to maintain their equanimity. I often imagine participants' internal dialogues. At $110, I picture them saying, "I'll buy like mad if it ever gets to $100." Because of the way investor psychology works, at $90 they may say, "If it falls to $70, I'll give serious thought to buying." But at $60 the tendency is to say, "It's a falling knife and there's no way to know where it'll stop; I wouldn't touch it at any price."

  It feels much better to buy assets while they're rising. But it's usually smarter to buy after they've fallen for a while. **Bottom line, as noted above: there's little logic in investor psychology.**

- I said it about gold in *All That Glitters* (November 2010), and it's equally relevant to oil: **it's hard to analytically put a price on an asset that doesn't produce income**. In principle, a non-perishable commodity won't be priced below the variable production cost of the highest-cost producer whose output is needed to satisfy total demand. But in reality and in the short run, strange things can happen. It's clear that today's oil price is well below that standard.

  It's hard to say what the right price is for a commodity like oil . . . and thus when the price is too high or too low. Was it too high at $100-plus, an unsustainable blip? History says no: it was there for 43 consecutive months through this past August. And if it wasn't too high then, isn't it laughably low today? The answer is that you just can't say. Ditto for whether the response of the price of oil to the changes in fundamentals has been appropriate, excessive or insufficient. And if

> you can't be confident about what the right price is, then you can't be definite about financial decisions regarding oil.

In the last few years, as I said in *The Role of Confidence* (August 2013), investor sentiment has been riding high. Or, as Doug Kass pointed out this past summer, there's been "a bull market in complacency." Regardless, it seems that a market that was unconcerned about things like oil and its impact on economies and assets now has lost its composure. Especially given the pervasive role of energy in economic life, uncertainty about oil introduces uncertainty into many aspects of investing.

"Value investing" – the form of investing Oaktree practices – is supposed to be about buying based on the present value of assets, rather than conjecture about profit growth in the far-off future. But you can't assess present value without taking some position on what the future holds, even if it's only assuming a continuation of present conditions or perhaps – for the sake of conservatism – a considerably lower level. Recent events cast doubt on the ability to safely take any position.

One of the things that's central to risk-conscious value investing is ascertaining the presence of a generous cushion in terms of "margin of safety." This margin comes from conviction that conditions will be stable, financial performance is predictable, and/or an entry price is low relative to the asset's intrinsic value. But when something as central as oil is totally up for grabs, as investors seem to think is the case today, it's hard to know whether you have an adequate margin. Referring to investing, Charlie Munger told me, "It's not supposed to be easy." The recent events surrounding oil certainly prove that it isn't.

On the other hand – and in investing there's <u>always</u> another hand – high levels of confidence, complacency and composure on the part of investors have in good measure given way to disarray and doubt, making many markets much more to our liking. For the last few years, interest rates on the safest securities – brought low by central banks – have been coercing investors to move out the risk curve. Sometimes they've made that journey without cognizance of the risks they were taking, and without thoroughly understanding the investments they undertook. Now they find themselves questioning many of their actions, and it feels like risk tolerance is being replaced by risk aversion. **This paragraph describes a process through which investors are made to feel pain, but also one that makes markets much safer and potentially more bargain-laden.**

In particular with regard to the distress cycle, confident and optimistic credit markets permit the unwise extension of credit to borrowers who are undeserving but allowed to become overlevered nevertheless. Negative subsequent developments can render providers of capital less confident, making the capital market less accommodative. This cycle of easy issuance followed by defrocking has been behind the three debt crises that delivered the best buying opportunities in our 26 years in distressed debt. We think it also holds the key to the creation of superior opportunities in the future.

We've argued for a few years that credit standards were dropping as investors – chasing yield – became less disciplined and less discerning. But we knew great buying opportunities wouldn't arrive until a negative "igniter" caused the tide to go out, exposing the debt's weaknesses. **The current oil crisis is an example of something with the potential to grow into that role. We'll see how far it goes.**

For the last 3½ years, Oaktree's mantra has been "move forward, but with caution." For the first time in that span, with the arrival of some disarray and heightened risk aversion, events tell us it's appropriate to drop some of our caution and substitute a degree of aggressiveness.

December 18, 2014

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Memo to: Oaktree Clients

From: Howard Marks

Re: Liquidity

My wife Nancy's accusations of repetitiveness notwithstanding, once in a while I think of something about which I haven't written much. Liquidity is one of those things. I'm not sure it's a profound topic, and perhaps my observations won't be either. But I think it's worth a memo.

Liquidity Defined

Sometimes people think of liquidity as the quality of something being readily saleable or marketable. For this, the key question is whether it's registered, publicly listed and legal for sale to the public. "Marketable securities" are liquid in this sense; you can buy or sell them in the public markets. "Non-marketable" securities include things like private placements and interests in private partnerships, whose salability is restricted and can require the qualification of buyers, documentation, and perhaps a time delay.

But the more important definition of liquidity is this one from *Investopedia*: "The degree to which an asset or security can be bought or sold in the market *without affecting the asset's price*." (Emphasis added) **Thus the key criterion isn't "can you sell it?" It's "can you sell it at a price equal or close to the last price?"** Most liquid assets are registered and/or listed; that can be a necessary but not sufficient condition. For them to be truly liquid in this latter sense, one has to be able to move them promptly and without the imposition of a material discount.

Liquidity Characterized

I often say many of the important things in investing are counter-intuitive. Liquidity is one of them. **In particular, it's probably more wrong than right to say without qualification that something is or isn't "liquid."**

If when people ask whether a given asset is liquid they mean "marketable" (in the sense of "listed" or "registered"), then that's an entirely appropriate question, and answering it is straightforward. Either something can be sold freely to the public or it can't.

But if what they want to know is how hard it will be to get rid of it if they change their mind or want to take a profit or avoid a possible loss – how long it will take to sell it, or how much of a markdown they'll have to take from the last price – that's probably not an entirely legitimate question.

It's often a mistake to say a particular asset is either liquid or illiquid. Usually an asset isn't "liquid" or "illiquid" by its nature. Liquidity is ephemeral: it can come and go. An asset's liquidity can increase or decrease with what's going on in the market. One day it can be easy to sell, and the next day hard. Or one day it can be easy to sell but hard to buy, and the next day easy to buy but hard to sell.

In other words, the liquidity of an asset often depends on which way you want to go . . . and which way everyone else wants to go. If you want to sell when everyone else wants to buy, you're likely to find your position is highly liquid: you can sell it quickly, and at a price equal to or above the last transaction. But if you want to sell when everyone else wants to sell, you may find your position is totally illiquid: selling may take a long time, or require accepting a big discount, or both. **If that's the case – and I'm sure it is – then the asset can't be described as being either liquid or illiquid. It's entirely situational**.

There's usually plenty of liquidity for those who want to sell things that are rising in price or buy things that are falling. That's great news, since much of the time those are the right actions to take. But why is the liquidity plentiful? For the simple reason that most investors want to do just the opposite. The crowd takes great pleasure from buying things whose prices are rising, and they often become highly motivated to sell things that are falling . . . notwithstanding that those may be exactly the **wrong** things to do.

Further, the liquidity of an asset is very much a function of the quantity involved. At a given time, a stock may be liquid if you want to sell a thousand shares but highly illiquid if you want to sell a million. **If so, it can't be said categorically that the stock is either liquid or illiquid. But people do it all the time.**

Investment managers are often asked how long it would take to liquidate a given portfolio. The answer usually takes the form of a schedule that says: "We could sell off x% of the portfolio in a day, y% in a week, and z% in a month, etc."

But that's a terribly simplistic answer. It doesn't say anything about how the price received would compare with the last trade or the price at which the assets were carried on the previous valuation date. Or about how changing market conditions might make the answer different a month from now. Bottom line: to the statement "we could sell off z% in a month" one should add "but who knows what the price will be, or what effect changing market conditions might have on that percentage?" Anything else requires an assumption that the assets' liquidity is constant. That's often far from the case.

Usually, just as a holder's <u>desire</u> to sell an asset <u>increases</u> (because he has become afraid to hold it), his <u>ability</u> to sell it <u>decreases</u> (because everyone else has also become afraid to hold it). Thus (a) things tend to be liquid when you don't need liquidity, and (b) just when you need liquidity most, it tends not to be there. (In the 2014 Berkshire Hathaway Annual Letter, released early this month, Warren Buffett expresses his dislike for "substitutes for cash that are claimed to deliver liquidity and actually do so, *except* when it is truly needed.") The truth is, things often seem more liquid when you buy than when you go to sell.

The bottom line is that it can be wrong to assume it'll be easy and painless to get out of your holdings, and especially to exit a position after its price has begun to drop.

<u>Liquidity and Opportunities</u>

We watch TV, listen to radio or read newspapers. I'm always amused when the pundits say, "stocks went up today because several companies beat analysts' earnings forecasts" or "the market dropped because of increased uncertainty regarding the price of oil." How do they know? Where do buyers or sellers register their motivations, such that the media can discern them so definitively?

There's only one indisputable explanation for why the market went up on a given day: there were more buyers than sellers. When buyers have greater influence in the market than sellers – because would-be buyers predominate relative to sellers; buyers feel more urgency than sellers; or buyers want to buy more shares than sellers want to sell – prices rise. Under those circumstances, sellers enjoy great liquidity, and buyers have to pay a premium over prior prices.

So there's the germ of a plan. Why not sell the things people are bidding for most strongly and buy the things they're eager to dump? That sounds like a good idea. It is, and that's why smart investors flock to it: **it's called contrarianism**.

One of the main reasons why opportunistic strategies like distressed debt investing can perform well is that investors are sometimes able to buy from sellers who outnumber them . . . who are in a hurry . . . who want to sell really badly . . . or who have to sell regardless of price. To achieve "immediacy" (a term for a quick exit coined by Richard Bookstaber), the sellers tend to sacrifice something else: price. And the price discount they accept makes an important contribution to the bargain hunter's excess return. (See *Investment Miscellany*, November 2000, for a thorough discussion of immediacy).

Random Thoughts on Liquidity

Here are a number of truths about liquidity. Some are important, but they don't fit into a coherent narrative.

- It's possible that liquidity can be relied on when sellers and buyers are balanced in number and degree of motivation. But more often, given the herd mentality in markets, "everyone" wants to either sell or buy at once.

  There's an old saying to the effect that "In times of crisis all correlations go to one." The prices of everything move in unison during crises because investors are driven by mob psychology, not fundamentals. Thus – and for the same reason – **in times of crisis liquidity often goes to zero**.

- Usually, as described above, it's either hard to buy but easy to sell, or hard to sell but easy to buy. **Sometimes, however, when everyone's confused and intimidated, the market freezes up and it can be hard to do both**.

  For example, after securities backed by sub-prime mortgages were thoroughly impugned in the crisis of 2007-08, there was a total lack of trading. The fact that the "last trade" occurred months ago made it hard for potential buyers and sellers to feel confident regarding what a fair price might be. I believe it was for this reason that the U.S. Treasury organized the Public Private Investment Partnership program, under which nine investment managers raised equity capital from clients for investment in mortgage backed securities, with the Treasury matching the equity and then supplying an equal amount of zero-cost leverage. The goal was to cause trading to occur, and with it "price discovery." After transactions resumed, buyers and sellers had a better idea what a fair price was, so trading and liquidity increased. This was one of the ways in which the government coaxed the capital markets to reopen. Yet this program is little known and its brilliance is unrecognized.

- It's one of my standing rules that **"No investment vehicle should promise greater liquidity than is afforded by its underlying assets."** If one were to do so, what would be the source of the increase in liquidity? Because there is no such source, the incremental liquidity is usually illusory, fleeting and unreliable, and it works (like a Ponzi scheme) until markets freeze up and the promise of liquidity is tested in tough times.

Some hedge funds provided an example in the last crisis. They raised capital with which to buy assets of uncertain liquidity, sometimes using leverage, and they promised investors the ability to withdraw their money quarterly or annually. But when the end of 2008 rolled around, the desire of LPs for liquidity overwhelmed the capacity of the marketplace to absorb the assets that were for sale (or perhaps the GPs wisely refused to sell because a fair price couldn't be obtained). When that occurred, the funds told LPs they couldn't have the liquidity they'd been promised. Illiquid assets went into locked-up "side pockets," and "gates" came down delaying the effective dates of withdrawals. These little-known provisions gave LPs an unpleasant surprise, demonstrating that **in a crisis, the promise of withdrawal from a vehicle holding illiquid assets can easily turn out to be too good to be true.**

- People often think about liquidity constraints as relating to specific assets; they don't necessarily think about the knock-on effects of illiquidity from asset to asset and market to market. For example, in the crisis, institutional investors had to sell liquid assets at steep discounts and redeem from the most liquid hedge funds because of the heavy allocations to illiquid strategies and gated funds elsewhere in their portfolios. The resulting elevated supply of assets for sale from these funds reduced the liquidity for sellers in those markets and put downward pressure on assets that shouldn't have been so affected.

- Specific investor actions can have a dramatic impact in illiquid markets. For example, the price of an illiquid asset can rise simply because one buyer is buying, in which case selling the asset becomes very easy. When that buyer stops buying, however, the market can quickly reset to much lower levels in terms of both price and the liquidity enjoyed by sellers (and it can overshoot in the other direction if the buyer decides to sell what he's bought).

- In assessing an asset's liquidity, one should think about the other people who hold it. Are they all the same type of investor, and thus likely to react the same to a given story on *Bloomberg*? Do many of them own it in funds whose investors have the right to make quick withdrawals? And, in particular, are they highly levered and subject to potential margin calls? The more ownership is concentrated in the hands of investors who could become motivated to sell *en masse*, the faster liquidity can disappear.

- **Taking on large amounts of illiquidity is neither a winning nor a losing strategy *per se*.** Like any other form of risk, it's advantageous to bear illiquidity when the incremental return for doing so is high, but a bad idea when it's not. And, needless to say, the liquidity premium is neither always there nor always generous.

  In my view, some endowments emulated Yale to excess in the years before the crisis, taking on too much illiquidity in the belief that (a) as ultra-long-term investors they could bear it and (b) they were sure to be well paid for doing so. **But risk premiums arise from risk aversion, meaning they may not exist when investors are risk-tolerant.** The willing acceptance of illiquidity in the early to mid-2000s caused the premium for bearing it to be inadequate, and investors who did so were penalized, not rewarded.

- On the other hand, at the right time, investors can make tremendous amounts of money simply by being willing to supply liquidity (or accept illiquidity). When everyone else is selling in panic or sitting frozen on the sideline, refusing to buy, cash can be king. Often when a crash follows a bubble-driven run-up, most people are short of cash (and/or the willingness to spend it).

But it may not be a good idea to always sit with a large amount of cash so as to be able to provide liquidity and scoop up bargains in a once-a-decade crash. This may equate to sub-optimizing. It would have paid off in 1990-91, 2001-02 and 2008-09, but what about the other 19 years in the last 25?

- **A high degree of concern over illiquidity can push investors to avoid it to excess.** For example, institutions whose realities could permit a long-term investment approach sometimes decide to invest only in things they can get out of quickly. Is this prudence, or merely sub-optimizing? Is it done in response to a threat that has a reasonable likelihood of materializing, or to a crisis while it is fresh in memory ("fighting the last war")? Is it realistic, or the result of an irrational desire to be able to turn the whole portfolio into cash in short order? Or is it done in order to always be able to comply with a sell order from the boss or the investment committee? **Liquidity is a good thing (everything else being equal). But is it smart to require that a portfolio be able to provide more liquidity than is ever likely to be called on? Let's remember that liquidity isn't free. There's usually a cost, and it comes in the form of return forgone.**

- I think the best way to deal with the issue of liquidity is to think of the portfolio in terms of layers ranging from highly liquid to totally illiquid. The appropriate size for each layer at a given point in time is a function of each investor's specific situation, as well as the position of the market in its cycle.

  In sizing those layers, it's clear that no investor should shoulder more illiquidity than its realities permit, as happened in 2008 with serious consequences for some endowments. Portfolios may be required to (a) meet their owners' needs for current cash with which to operate, (b) fund capital drawdowns at a time when lock-up funds aren't making distributions, or (c) enable the owners to avoid having to sell assets at depressed prices. Thus portfolio liquidity should be set so these needs can be met in bad times.

  But how bad is bad? Should the portfolio have to respond to the last bad year, the average of the last five bad years, the worst year ever . . . or something worse? These decisions require judgment.

- Finally, excessive liquidity can do more harm than good, and investors can be better off if they're able to trade less rather than more. **My son Andrew makes a number of excellent points on the theme that liquidity is a good thing, but not necessarily all good:**

  - The siren song of liquidity can convince investors to try their hand as traders. The result can be increases in (a) emphasis on short-term considerations relative to long-term ones, (b) transaction costs and taxes, and (c) exposure to negative surprises when the liquidity they've been enjoying and counting on disappears.

  - Liquidity can cause you to lower the bar for investments. If you're thinking about making an investment you know you won't be able to exit for years, you'll probably do thorough due diligence, make conservative assumptions and apply skepticism, etc. But when you have something that appears very liquid, you may take a position casually, with little work or conviction, under the assumption that it would be easy and cheap to get out. Here's a great quote on the subject from Warren Buffett:

> If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.

- Certainly owners of companies wouldn't (and couldn't) trade in and out of them every day. If you intend to invest in businesses based on their fundamentals – rather than trading based on short-term market dynamics – it's critical to think and act like a long-term owner.

- When you find an investment with the potential to compound over a long period of time, one of the hardest things is to be patient and maintain your position as long as doing so is warranted on the basis of the prospective return and risk. Investors can easily be moved to sell by news, emotion, the fact that they've made a lot of money to date, or the excitement of a new, seemingly more promising idea. **When you look at the chart for something that's gone up and to the right for 20 years, think about all the times a holder would have had to convince himself not to sell.** An abundance of liquidity can be a handicap in this regard. Here's some more good advice from Warren: "If you can enjoy Saturdays and Sundays without looking at stock prices, give it a try on weekdays." Looking less often would improve most investors' results.

I have particularly strong feelings about the insistence that 401(k) retirement accounts include only investment choices that provide daily pricing and liquidity. I've heard from Oaktree pension clients about employees who frequently trade their 401(k) accounts. It can't be a good thing for these portfolios to be constantly rejiggered. **It's hard enough to make an occasional well-reasoned long-term decision, but much harder to make a large number of correct short-term decisions.** Rather than ensuring daily liquidity, the people in charge could help plan participants by limiting them to annual changes at most.

So liquidity – like most other things in the investment world – is multi-faceted and complex, not simple. There are a lot of considerations to be taken into account, and certainly no simple formula for doing so. Like everything else in investing, there's no surefire way to manage the issue of liquidity in the absence of superior insight.

Influences on Liquidity Today

Many factors cause the availability of liquidity to change over time. The biggest factor lately in some of our credit markets has been the growth of demand through mutual funds and ETFs, or Exchange-Traded Funds. While there's been no real mania for stocks, the ultra-low level of interest rates has driven many retail investors (who in the past may have invested in Treasurys and money market funds) to credit vehicles instead.

Witness, for example, the fact that senior loan mutual funds saw net inflows of capital for 95 straight weeks leading up to April 2014. That's almost two solid years without a break. You might expect that to cause an imbalance of demand over supply, rendering buyers unable to get their fill. But Wall Street abhors a vacuum, and the banks were able to round up enough issuers to satisfy the buyers. **And with large numbers of retail buyers on one side and obliging issuers on the other, the market certainly**

looked liquid. But when mutual fund inflows turned into outflows in the second half of 2014, the supply of loans put up for sale to meet redemptions added to the supply of loans issued by companies seeking capital. Thus the total supply of loans for sale exceeded the demand, causing prices to decline and the market to become less liquid for holders.

Investors in mutual funds think of them as highly liquid. "You can get out any day," the ads say, "Just call the 800 number." But withdrawing from a mutual fund (if there isn't adequate cash in the fund to meet the redemption) is equivalent to requiring the portfolio manager to enter a "market held" order for some of the securities in the fund's portfolio: sell regardless of price. And the depressed price that results from the involuntary sale of securities is the same price that's paid to the redeeming fund investor.

That's because the mutual fund investor may enter his redemption order at 6:00 p.m. on Monday or 10:00 a.m. on Tuesday, but the price he gets will be determined in an NAV calculation after the close of trading Tuesday. He doesn't get the price that prevailed before the sell order occasioned by his redemption was entered. Thus a mutual fund may be "highly liquid," but that's not the same as "100% liquid," and **it's certainly not more liquid than the assets in its portfolio.**

The other source of increasing demand for securities of late has been ETFs. ETF-like vehicles, sometimes known as "tracking shares," began to appear in the early 1990s, and they proliferated significantly after 2000. According to Wikipedia, "As of January 2014, there were over 1,500 ETFs traded in the U.S., with over $1.7 trillion in assets." (Several years ago I cited Wikipedia in a memo, and Oaktree co-founder Richard Masson – a stickler for correctness – told me in no uncertain terms that it wasn't a respectable source. I think things have changed enough since then, Richard: I'm citing it!)

ETF's have become popular because they're generally believed to be "better than mutual funds," in that they're traded all day. Thus an ETF investor can get in or out anytime during trading hours, whereas with mutual funds he has to wait for a pricing at the close of business. "If you're considering investing," the pitch goes, "why do so through a vehicle that can require you to wait hours to cash out?" **But do the investors in ETFs wonder about the source of their liquidity?**

Here's what Wikipedia has to say about the liquidity of ETFs:

> An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value. . . .

Consider the possibility that many of the holders of an ETF become highly motivated to either buy or sell. Their actions theoretically could cause the trading price of the ETF to diverge from the value of the securities in the underlying portfolio. To minimize that risk, the creators of ETFs established a mechanism through which financial institutions can trade in wholesale quantities of "creation units" of the fund at NAV.

> The ability to purchase and redeem creation units gives ETFs an arbitrage mechanism intended to minimize the potential deviation between the market price and the net asset value of ETF shares. Existing ETFs have transparent portfolios, so institutional investors will know exactly what portfolio assets they must assemble if they wish to purchase a creation unit, and the exchange disseminates the updated net asset value of the shares throughout the trading day, typically at 15-second intervals.

> If there is strong investor demand for an ETF, its share price will temporarily rise above its net asset value per share, giving arbitrageurs an incentive to purchase additional creation units from the ETF and sell the component ETF shares in the open market. The additional supply of ETF shares reduces the market price per share, generally eliminating the premium over net asset value. A similar process applies when there is weak demand for an ETF: its shares trade at a discount from net asset value.

What would happen, for example, if a large number of holders decided to sell a high yield bond ETF all at once? In theory, the ETF can always be sold. Buyers may be scarce, but there should be some price at which one will materialize. Of course, the price that buyer will pay might represent a discount from the NAV of the underlying bonds. In that case, a bank should be willing to buy the creation units at that discount from NAV and short the underlying bonds at the prices used to calculate the NAV, earning an arbitrage profit and causing the gap to close. But then we're back to wondering about whether there will be a buyer for the bonds the bank wants to short, and at what price. **Thus we can't get away from depending on the liquidity of the underlying high yield bonds. The ETF can't be more liquid than the underlying, and we know the underlying can become highly illiquid.**

This whole discussion calls to mind a Wall Street Wonder called "auction rate securities." They were popular ten years ago, but today they're only a footnote to financial history. In brief, auction rate securities were developed to satisfy the desire of borrowers for long-term financing at the lower interest rates on short-term debt. The securities were described as safe and liquid because Dutch auctions would be held every week or month, resetting the yield on the securities to contemporary levels and thereby ensuring a price near par, as well as plentiful liquidity. Certainly there would always be **some** yield capable of enticing investors to buy at par. Thus the securities would be free from the risks associated with long-term debt. That's what **should** have happened. Here's what Wikipedia says did happen:

> Beginning on Thursday, February 7, 2008, auctions for these securities began to fail when investors declined to bid on the securities. The four largest investment banks who make a market in these securities (Citigroup, UBS AG, Morgan Stanley and Merrill Lynch) declined to act as bidders of last resort, as they had in the past. *This was a result of the scope and size of the market failure, combined with the firms' needs to protect their capital during the 2008 financial crisis.* (Emphasis added)
>
> On February 13, 2008, 80% of auctions failed. On February 20, 62% failed (395 out of 641 auctions) . . . .

When the auctions failed, auction rate securities became frozen. Holders saw large markdowns and for years were unable to obtain liquidity. Eventually, the investment banks that had issued the securities bought many of them back at par, under threat of investigation by U.S. attorneys general. And one more "miracle" disappeared from the scene.

Lastly on the subject of ETFs, a senior loan ETF can be sold for settlement in three days, whereas if there are tenders of creation units, sales of loans to raise the funds with which to pay for those units may require a week or considerably more to settle. What are the implications of such a mismatch?

So-called "liquid alternatives" or "liquid alts" are another recent innovation. They're supposed to deliver performance comparable to other alternative investments without the illiquidity they entail. To me it sounds like just one more promise of something for nothing. How many portfolio managers are smart enough, for example, to deliver the alpha of a well-managed hedge fund without accepting the illiquidity that the clever manager of that hedge fund feels he has no choice but to bear?

Financial innovations created in good times often fool people into thinking a silver bullet has been invented that offers a better deal than traditional investments. (By "traditional" I mean investments that are acknowledged to entail increased risk as the price for targeting increased return . . . not the "miracles" where increased return comes gratis.) Many recent innovations have promised high liquidity from low-liquidity assets. As I said on page three, however, no investment vehicle should promise more liquidity than is afforded by its underlying assets. Do these recent promises represent real improvements, or merely the seeds for subsequent disappointment?

Auction rate securities were a way to buy long-term debt securities without interest-rate risk and illiquidity. Likewise, ETFs offer a liquid way to invest in potentially illiquid markets. But these instruments rely for their desirable outcomes on the assumption that other parties will do what they "should" do. Over the course of my career I've seen many instances when market participants failed to do what they were supposed to do. The related financial innovations often remind me of my father's story about the habitual gambler who finally found a sure thing: a race with only one horse. He bet all his money, but halfway around the track the horse jumped over the fence and ran away. **Will ETFs prove liquid in the next crisis? And what impact will mass sales of ETFs have on the prices of underlying assets? We'll find out.**

Finally under the heading of recent developments, I want to mention the Volcker Rule, which arose from a suggestion from former Fed chairman Paul Volcker. The main reason for the 2008 government bailouts of systemically important banks was the losses the banks had suffered thanks to unsuccessful investments made with their proprietary capital in mortgage backed securities and other levered assets. When these collapsed, the banks lost a great deal of their capital, such that they required capital injections only the government could or would make.

In response to that experience, legislators decided to incorporate the Volcker Rule into the Dodd–Frank Wall Street Reform and Consumer Protection Act, the main piece of regulation to emerge after the crisis. Although there has been much back-and-forth regarding its modification and enactment, the main thrust of the Volcker Rule is to prevent banks from making speculative investments that aren't related to their activities on behalf of clients; in other words, to impose a general ban on proprietary trading**.**

Often during crises, investors take to the sidelines, such that there are no buyers for the assets that come up for sale. Liquidity dries up, and prices plummet. In the past, banks have stepped forward, risking their proprietary capital in pursuit of profit. Many times in our experience, banks have competed strongly against us to buy distressed debt, thereby supplying liquidity to the market. Although the eventual impact of the Volcker Rule is unknown, **any diminution of the banks' likelihood of engaging in proprietary buying during crises suggests a significant reduction in liquidity just when it may be needed most.**

For the last few years I've been expressing my view that (a) investors – driven by central bank-mandated interest rates near zero – have been moving into riskier investments in pursuit of higher returns and (b) in taking that step they've often ignored the need for caution or been ignorant as to how to achieve it. **I believe that as an important part of this behavior, those investors have extrapolated the high level of liquidity they've witnessed in the last five years, failing to understand its transitory nature.**

The impact on liquidity of ETFs, liquid alternatives and the Volcker Rule has yet to be tested in tough times. We'll see what happens in the next serious downturn.

* * *

The bottom line is unambiguous. Liquidity can be transient and paradoxical. It's plentiful when you don't care about it and scarce when you need it most. Given the way it waxes and wanes, it's dangerous to assume the liquidity that's available in good times will be there when the tide goes out.

What can an investor do about this unreliability? The best preparation for bouts of illiquidity is:

- **buying assets, hopefully at prices below durable intrinsic values, that can be held for a long time – in the case of debt, to its maturity – even if prices fall or price discovery ceases to take place, and**
- **making sure that investment vehicle structures, leverage arrangements (if any), manager/client relationships and performance expectations will permit a long-term approach to investing.**

These are the things we try to do.

And the worst defenses against illiquidity – or, better said, the approaches that make you most dependent on the availability of liquidity – are (a) employing trading strategies under which you buy things because of how you think they'll perform in the short run, not what they'll be worth in the long run, (b) being focused on what the market says your assets are worth, not what your analysis shows them to be worth, and (c) buying with leverage that exposes you to the risk of a margin call in a declining market.

One of the great advantages of investing in performing debt is that if our credit judgments are correct, the return will come from our contractual relationship with the issuers – from the interest and principal they've promised to pay us – not the operation of the market. **At Oaktree, trading is what we do to implement portfolio managers' long-term investment decisions. We generally consider it a cost of doing business, not something we engage in to make money.**

There are two benefits to this approach:

- we aren't highly reliant on liquidity for success, and
- rather than be weakened in times of illiquidity, we can profit from crises by investing more – at lower prices – when liquidity is scarce.

We're not immune to occasional periods of illiquidity; our holdings become just as hard to sell as anyone else's. But with the proper structure and approach, it's possible to turn such periods to our advantage rather than just endure them.

* * *

I started this memo by saying liquidity might not be a profound topic. But when I ran a draft by our CEO Jay Wintrob, who came to us in November from AIG, he took issue. I'll give him the last word:

> In September 2008, AIG experienced serious liquidity issues (despite its $1 trillion balance sheet) when it couldn't post $20-25 billion of liquid collateral related to credit default swap contracts written by one of its subsidiaries. The U.S. government stepped in

as a result, lending support that eventually reached $182.3 billion, massively diluting AIG shareholders in the process. **When you can't meet a margin call because you have insufficient liquidity, that's profound.**

March 25, 2015

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Memo to: Oaktree Clients

From: Howard Marks

Re: Risk Revisited Again

The operators of racetracks take a dim view of bettors who engage in "past-posting": trying to get a bet down after the race is over (and the horses are "past the post"). In that vein, it's been my practice not to rewrite old memos as new developments arise or new ideas strike me. However, while preparing "Risk Revisited" of September 2014 for inclusion in a compilation of my memos, I thought of a number of ways in which it could be made better. And since it was my original intention to have it contain everything I know about risk, I've decided to incorporate them. To make it clear which sections are new, I've put them in italics.

In April 2014, I had good results with *Dare to Be Great II*, starting from the base established in an earlier memo (*Dare to Be Great*, September 2006) and adding new thoughts that had occurred to me in the intervening years. Also in 2006 I wrote *Risk*, my first memo devoted entirely to this key subject. My thinking continued to develop, causing me to dedicate three chapters to risk among the twenty in my book *The Most Important Thing*. This memo adds to what I've previously written on the topic.

What Risk Really Means

In the 2006 memo and in the book, I argued against the purported identity between volatility and risk. Volatility is the academic's choice for defining and measuring risk. I think this is the case largely because volatility is quantifiable and thus usable in the calculations and models of modern finance theory. In the book I called it "machinable," and there is no substitute for the purposes of the calculations.

However, while volatility is quantifiable and machinable – and can be an indicator or symptom of riskiness and even a specific form of risk – I think it falls far short as "the" definition of investment risk. In thinking about risk, we want to identify the thing that investors worry about and thus demand compensation for bearing. I don't think most investors fear volatility. In fact, I've never heard anyone say, "The prospective return isn't high enough to warrant bearing all that volatility." **What they fear is the possibility of permanent loss.**

Permanent loss is very different from volatility or fluctuation. A downward fluctuation – which by definition is temporary – doesn't present a big problem if the investor is able to hold on and come out the other side. A permanent loss – from which there won't be a rebound – can occur for either of two reasons: (a) an otherwise-temporary dip is locked in when the investor sells during a downswing – whether because of a loss of conviction; requirements stemming from his timeframe; financial exigency; or emotional pressures, or (b) the investment itself is unable to recover for fundamental reasons. We can ride out volatility, but we never get a chance to undo a permanent loss.

Of course, the problem with defining risk as the possibility of permanent loss is that it lacks the very thing volatility offers: quantifiability. **The probability of loss is no more measurable than the probability of rain.** It can be modeled, and it can be estimated (and by experts pretty well), but it cannot be known.

In *Dare to Be Great II*, I described the time I spent advising a sovereign wealth fund about how to organize for the next thirty years. My presentation was built significantly around my conviction that risk can't be quantified *a priori*. Another of their advisors, a professor from a business school north of New York, insisted it can. This is something I prefer not to debate, especially with people who're sure they have the answer but haven't bet much money on it.

One of the things the professor was sure could be quantified was the maximum a portfolio could fall under adverse circumstances. But how can this be so if we don't know how adverse circumstances can be or how they will influence returns? We might say "the market probably won't fall more than x% as long as things aren't worse than y and z," but how can an absolute limit be specified? I wonder if the professor had anticipated that the S&P 500 could fall 57% in the global crisis.

While writing the original memo on risk in 2006, an important thought came to me for the first time. Forget about *a priori*; if you define risk as anything other than volatility, it can't be measured **even after the fact**. If you buy something for $10 and sell it a year later for $20, was it risky or not? The novice would say the profit proves it was safe, while the academic would say it was clearly risky, since the only way to make 100% in a year is by taking a lot of risk. I'd say it might have been a brilliant, safe investment that was sure to double <u>or</u> a risky dart throw that got lucky.

If you make an investment in 2012, you'll know in 2014 whether you lost money (and how much), but you won't know whether it was a risky investment – that is, what the probability of loss was at the time you made it. To continue the analogy, **it may rain tomorrow, or it may not, but nothing that happens tomorrow will tell you what the probability of rain was as of today. And the risk of rain is a very good analogue (although I'm sure not perfect) for the risk of loss.**

<u>*People Smarter Than Me*</u>

Peter Bernstein, who passed away in 2009, was one of the smartest people I ever met: a real investment sage. He combined a brilliant and learned mind, great common sense, and the ability to express himself with incredible clarity. I found a great deal of inspiration in his newsletter "Economics and Portfolio Strategy," in his book "Against the Gods: The Remarkable Story of Risk," and in our correspondence.

One of the newsletter's best issues, from June 2007, was titled "Can We Measure Risk with a Number?" It provided Peter's answer to that question, buttressed by the words of a number of great thinkers. It's so good that I want to share parts here (with all emphasis added but the first). This memo is greatly enhanced by their inclusion:

> *In life – and in investing – the biggest risks cannot be reduced to a hard number. As Bill Sharpe put it to me recently, "It's dangerous, at least in general, to think of risk as a number . . . . The problem we face is that there are many scenarios that can unfold in the future. . . ." John Maynard Keynes, [in the 1920s], had this to say: "There is little likelihood of our discovering a method of recognizing particular probabilities, without any assistance whatever from intuition or direct judgment. . . . A proposition is not probable because we think it so."*
>
> *Consider the following story. In 1703, the great Swiss mathematician Jacob Bernoulli wrote Leibniz he thought it strange that we knew the odds of throwing a seven instead of an eight with dice, but we do not know the probability that a man of twenty will outlive a man of sixty. He proposed following a large number of pairs of men to see whether he could arrive at the probability that a man of twenty will outlive a man of sixty. Leibniz was unimpressed. "Nature has established patterns originating in the return of events, **but only for the most part**. . . . No matter how many experiments . . . you have*

conducted, you have not thereby imposed a limit on the nature of events so that in the future they would not vary." Leibniz had written to Bernoulli in Latin, as was customary for exchanges between intellectuals in those days, but he put "but only for the most part" in Greek, to give it maximum emphasis. If it were "always," there would be no uncertainty, no risk.

"But only for the most part" is what risk is all about: uncertainty. *The key hazard of quantitative risk management is the illusion of control the models and their results impart to us. No model has an R^2 of 1.000. Even if you have a so-called statistically significant outcome, which is 95% certain – and that is surely "for the most part" – 95% still leaves 5% you know nothing about. The devil is in the residuals, as all of us have discovered to our sorrow.*

I have pursued this discussion of the nature of risk, and our inability to accurately measure risk, because I think it sheds important light on how we should think about the current environment, where the economic risks appear to be moderate and manageable and where the environment itself seems to have so many self-reinforcing elements. I believe we have to look at the environment in qualitative terms, not quantitative terms. Only then can we develop an answer to the question of whether, in today's global economy, we have ended "the slings and arrows of outrageous fortune," as so many appear to believe. [Bernstein demonstrated considerable foresight in writing this paragraph and the next four in the lead-up to the global financial crisis.]

Can we sustain the low-risk character of the environment when it leads many investors to take high risks and to overvalue risky assets in search for higher returns? . . . The more risk we take because we believe the environment is low-risk in character, the less the environment continues to be low-risk in character.

. . . The more we emphasize the low risks in the environment, the more we point out and explain its features, and the more we believe we understand what is going on – unique as this environment may be – the weaker our normal and rational inclination to risk aversion becomes and the more our actions alter the character of the environment.

The economist Hyman Minsky has reminded us, ***"Each state nurtures forces that lead to its own destruction."*** *All of history testifies to the truth of this observation. Greater liquidity [by which Bernstein meant greater availability of funds] leads firms to borrow more than before. But higher levels of debt mean increasing vulnerability to adversity and negative shocks in an ever-changing world. For these reasons, as Minsky put it, stability leads inevitably to instability. . . .*

Even places that were once banana-republics, like Argentina and Brazil, are issuing long-term bonds and even issuing bonds denominated in foreign currencies. The eagerness to lend in so many different ways in so many different markets is a potent symptom of confidence in the underlying stability of the global system. . . .

Shocks and surprises are what the history of investment is all about. Here is what G. K. Chesterton had to say on this matter . . . :

> *The real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable, but not quite.* ***Life is not an***

> ***illogicality; yet it is a trap for logicians. It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait.***

Beginning on page 9, you'll find a section borrowed from a memo I wrote back in 2007. Its first bullet point starts off as follows: "Risk exists only in the future. . . ." That notion holds a good part of the key to understanding investment risk. ***If you accept that the underlying processes affecting economics, business and market psychology are less than 100% dependable, as seems obvious, then it follows that the future isn't knowable. In that case, risk can be nothing more than the subject of estimation – Keynes's "intuition or direct judgment" (see page 2) – and certainly not reliably quantified.***

<u>The Unknowable Future</u>

It seems most people in the prediction business think the future is knowable, and all they have to do is be among the ones who know it. Alternatively, they may understand (consciously or unconsciously) that it's not knowable but believe they have to act as if it is in order to make a living as an economist or investment manager.

On the other hand, I'm solidly convinced the future isn't knowable. I side with John Kenneth Galbraith who said, "We have two classes of forecasters: Those who don't know – and those who don't know they don't know." There are several reasons for this inability to predict:

- We're well aware of many factors that can influence future events, such as governmental actions, individuals' spending decisions and changes in commodity prices. But these things are hard to predict, and I doubt anyone is capable of taking all of them into account at once. (People have suggested a parallel between this categorization and that of Donald Rumsfeld, who might have called these things "known unknowns": the things we know we don't know.)

- The future can also be influenced by events that aren't on anyone's radar today, such as calamities – natural or man-made – that can have great impact. The 9/11 attacks and the Fukushima disaster are two examples of things no one knew to think about. (These would be "unknown unknowns": the things we don't know we don't know.)

- There's far too much randomness at work in the world for future events to be predictable. As 2014 began, forecasters were sure the U.S. economy was gaining steam, but they were confounded when record cold weather caused GDP to fall 2.9% in the first quarter.

- And importantly, the connections between contributing influences and future outcomes are far too imprecise and variable for the results to be dependable.

That last point deserves discussion. Physics is a science, and for that reason an electrical engineer can guarantee you that if you flip a switch over here, a light will go on over there . . . every time. But there's good reason why economics is called "the dismal science," and in fact it isn't much of a science at all. In just the last few years we've had opportunity to see – contrary to nearly unanimous expectations – that interest rates near zero can fail to produce a strong rebound in GDP, and that a reduction of bond buying on the part of the Fed can fail to bring on higher interest rates. In economics and investments, because of the key role played by human behavior, you just can't say for sure that "if A, then B," as you can in real science. The weakness of the connection between cause and effect makes outcomes uncertain. In other words, it introduces risk.

Given the near-infinite number of factors that influence developments, the great deal of randomness present, and the weakness of the linkages, it's my solid belief that future events cannot be predicted with any consistency. In particular, predictions of important divergences from trends and norms can't be made with anything approaching the accuracy required for them to be helpful.

Coping with the Unknowable Future

Here's the essential conundrum: investing requires us to decide how to position a portfolio for future developments, but the future isn't knowable.

Taken to slightly greater detail:

- Investing requires the taking of positions that will be affected by future developments.
- The existence of negative possibilities surrounding those future developments presents risk.
- Intelligent investors pursue prospective returns that they think compensate them for bearing the risk of negative future developments.
- But future developments are unpredictable.

How can investors deal with the limitations on their ability to know the future? **The answer lies in the fact that not being able to know the future doesn't mean we can't deal with it.** It's one thing to know what's going to happen and something very different to have a feeling for the range of possible outcomes and the likelihood of each one happening. Saying we can't do the former doesn't mean we can't do the latter.

The information we're able to estimate – the list of events that might happen and how likely each one is – can be used to construct a probability distribution. **Key point number one in this memo is that the future should be viewed not as a fixed outcome that's destined to happen and capable of being predicted, but as a range of possibilities and, hopefully on the basis of insight into their respective likelihoods, as a probability distribution.**

Since the future isn't fixed and future events can't be predicted, risk cannot be quantified with any precision. I made the point in *Risk*, and I want to emphasize it here, that risk estimation has to be the province of experienced experts, and their work product will by necessity be subjective, imprecise, and more qualitative than quantitative (even if it's expressed in numbers).

There's little I believe in more than Albert Einstein's observation: **"Not everything that counts can be counted, and not everything that can be counted counts."** I'd rather have an order-of-magnitude approximation of risk from an expert than a precise figure from a highly educated statistician who knows less about the underlying investments. British philosopher and logician Carveth Read put it this way: "It is better to be vaguely right than exactly wrong."

By the way, in my personal life I tend to incorporate another of Einstein's comments: "I never think of the future – it comes soon enough." We can't take that approach as investors, however. We have to think about the future. We just shouldn't accord too much significance to our opinions.

We can't know what will happen. We can know something about the possible outcomes (and how likely they are). People who have more insight into these things than others are likely to make superior investors. As I said in the last paragraph of *The Most Important Thing*:

> Only investors with unusual insight can regularly divine the probability distribution that governs future events and sense when the potential returns compensate for the risks that lurk in the distribution's negative left-hand tail.

In other words, in order to achieve superior results, an investor must be able – with some regularity – to find asymmetries: instances when the upside potential exceeds the downside risk. That's what successful investing is all about.

<u>Thinking in Terms of Diverse Outcomes</u>

It's the indeterminate nature of future events that creates investment risk. **It goes without saying that if we knew everything that was going to happen, there wouldn't be any risk.**

The return on a stock will be a function of the relationship between the price today and the cash flows (income and sale proceeds) it will produce in the future. The future cash flows, in turn, will be a function of the fundamental performance of the company and the way its stock is priced given that performance. We invest on the basis of expectations regarding these things. It's tautological to say that if the company's earnings and the valuation of those earnings meet our targets, the return will be as expected. The risk in the investment therefore comes from the possibility that one or both will come in lower than we think.

To oversimplify, investors in a given company may have an expectation that if A happens, that'll make B happen, and if C and D also happen, then the result will be E. Factor A may be the pace at which a new product finds an audience. That will determine factor B, the growth of sales. If A is positive, B should be positive. Then if C (the cost of raw materials) is on target, earnings should grow as expected, and if D (investors' valuation of the earnings) also meets expectations, the result should be a rising share price, giving us the return we seek (E).

We may have a sense for the probability distributions governing future developments, and thus a feeling for the likely outcome regarding each of developments A through E. The problem is that for each of these, there can be lots of outcomes other than the ones we consider most likely. The possibility of less-good outcomes is the source of risk. **That leads me to <u>key point number two</u>, as expressed by Elroy Dimson, a professor at the London Business School: "Risk means more things can happen than will happen."** This brief, pithy sentence contains a great deal of wisdom.

People who rely heavily on forecasts seem to think there's only one possibility, meaning risk can be eliminated if they just figure out which one it is. The rest of us know many possibilities exist today, and it's not knowable which of them will occur. Further, things are subject to change, meaning there will be new possibilities tomorrow. **This uncertainty as to which of the possibilities will occur is the source of risk in investing.**

<u>Even a Probability Distribution Isn't Enough</u>

I've stressed the importance of viewing the future as a probability distribution rather than a single predetermined outcome. **It's still essential to bear in mind <u>key point number three</u>: Knowing the**

probabilities doesn't mean you know what's going to happen. For example, all good backgammon players know the probabilities governing throws of two dice. They know there are 36 possible outcomes, and that six of them add up to the number seven (1-6, 2-5, 3-4, 4-3, 5-2 and 6-1). Thus the chance of throwing a seven on any toss is 6 in 36, or 16.7%. There's absolutely no doubt about that. But even though we know the probability of each number, we're far from knowing what number will come up on a given roll.

Backgammon players are usually quite happy to make a move that will enable them to win unless the opponent rolls twelve, since only one combination of the dice will produce it: 6-6. The probability of rolling twelve is thus only 1 in 36, or less than 3%. But twelve does come up from time to time, and the people it turns into losers end up complaining about having done the "right" thing but lost. As my friend Bruce Newberg says, **"There's a big difference between probability and outcome."** Unlikely things happen – and likely things fail to happen – all the time. **Probabilities are likelihoods and very far from certainties.**

It's true with dice, and it's true in investing . . . and not a bad start toward conveying the essence of risk. Think again about the quote above from Elroy Dimson: "Risk means more things can happen than will happen." **I find it particularly helpful to invert Dimson's observation for <u>key point number four</u>: Even though many things can happen, only one will.**

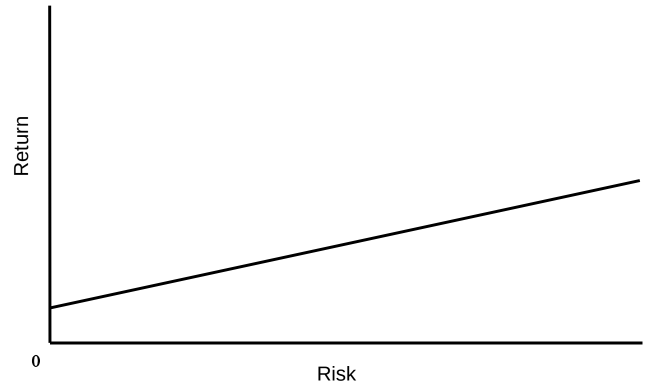
In *Dare to Be Great II*, I discussed the fact that economic decisions are usually best made on the basis of "expected value": you multiply each potential outcome by its probability, sum the results, and select the path with the highest total. *But while expected value represents the probability-weighted average of all possible outcomes, we can be certain it will <u>not</u> be the outcome (unless by coincidence it's one of the possibilities). Clearly just one of the many things that can happen will happen – not the average of all of them. And if some of the paths under consideration include individual outcomes that are absolutely unacceptable, we might not be able to choose on the basis of the highest expected value. We may have to shun the quantitatively optimal path in order to avoid the possibility of an extreme negative outcome.* I always say I have no interest in being a skydiver who's successful 95% of the time.

Investment performance (like life in general) is a lot like choosing a lottery winner by pulling one ticket from a bowlful. The process through which the winning ticket is chosen can be influenced by physical processes, and also by randomness. But it never amounts to anything but one ticket picked from among many. **Superior investors have a better sense for what's in the bowl, and thus for whether it's worth buying a ticket in a lottery.** *But even they don't know for sure which one will be chosen.* Lesser investors have less of a sense for the probability distribution and for whether the likelihood of winning the prize compensates for the risk that the cost of the ticket will be lost.

<u>Risk and Return</u>

Both in the 2006 memo on risk and in my book, I showed two graphics that together make clear the nature of investment risk. People have told me they're the best thing in the book, and since readers of this memo might have not seen the old one or read the book, I'm going to repeat them here.

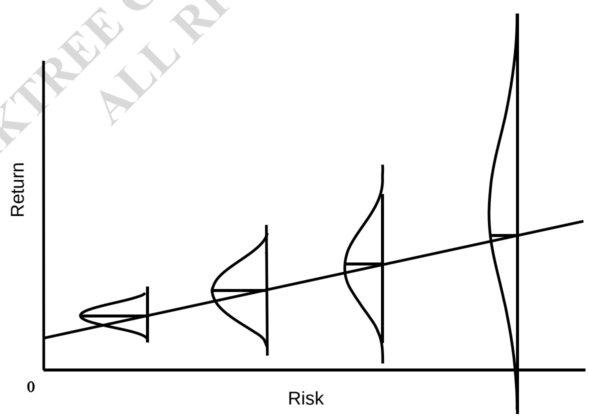
The first one below shows the relationship between risk and return as it is conventionally represented. The line slopes upward to the right, meaning the two are "positively correlated": as risk increases, return increases.



In both the old memo and the book, I went to great lengths to clarify what this is often – but erroneously – taken to mean. We hear it all the time: "Riskier investments produce higher returns" and "If you want to make more money, take more risk."

Both of these formulations are terrible. **In brief, if riskier investments could be counted on to produce higher returns, they wouldn't be riskier.** Misplaced reliance on the benefits of risk bearing has led investors to some very unpleasant surprises.

However, there's another, better way to describe this relationship: "Investments that seem riskier have to appear likely to deliver higher returns, or else people won't make them." This makes perfect sense. If the market is rational, the price of a seemingly risky asset will be set low enough that the reward for holding it appears adequate to compensate for the risk present. But note the word "appear." We're talking about investors' opinions regarding future return, not facts. Risky investments are – by definition – far from certain to deliver on their promise of high returns. For that reason, I think the graphic below *(with the probability distributions redrawn from those of the 2014 version of this memo)* does a much better job of portraying reality:



Here the underlying relationship between risk and return reflects the same positive general tendency as the first graphic, but the result of each investment is shown as a range of possibilities, not the single outcome suggested by the upward-sloping line. At each point along the horizontal risk axis, an investment's prospective return is shown as a bell-shaped probability distribution turned on its side.

The conclusions are obvious from inspection. As you move to the right, increasing the risk:

- the expected return increases (as with the traditional graphic),
- the range of possible outcomes becomes wider, and
- the less-good outcomes become worse.

This is the essence of investment risk. Riskier investments are ones where the investor is less secure regarding the eventual outcome and faces the possibility of faring worse than those who stick to safer investments, and even of losing money. These investments are undertaken because the expected return is higher. But things may happen other than that which is hoped for. Some of the possibilities are superior to the expected return, but others are decidedly unattractive.

The first graph's upward-sloping line indicates the underlying directionality of the risk/return relationship. But there's a lot more to consider than the fact that expected returns rise along with perceived risk, and in that regard the first graph is highly misleading. The second graph shows both the underlying trend <u>and</u> the increasing potential for actual returns to deviate from expectations. While the expected return rises along with risk, so does the probability of lower returns . . . and even of losses. **This way of looking at things reflects Professor Dimson's dictum that more than one thing can happen. That's reality in an unpredictable world.**

<u>*The Challenge of Managing Risk*</u>

The foregoing has been somewhat philosophical and theoretical. To provide a glimpse at how risk operates in the real world, and even though you may have read it earlier, I reproduce here (with minor modifications) a section that appeared with the above title in my memo "No Different This Time – The Lessons of '07" (December 2007). It points out some of the ways in which risk deviates in practice from the risk of theory. Each of these "realities" adds a degree of complexity that wouldn't exist if risk were quantifiable, linear and dependable, and thus easily treated. ***But then it wouldn't be risk.***

One of the reasons investor confidence was hit so hard [in 2007] is simply that it was too high (as is required for unsustainable market highs to be reached). And much of investors' excessive comfort was in the area of risk, where it was roundly believed things were under control. But the truth is, it's hard to manage risk.

As I stated in "Risk" (February 2006), investment risk is largely invisible – before the fact, except perhaps to people with unusual insight, and even after an investment has been exited. For this reason, many of the great financial disasters we've seen have been failures to foresee and manage risk. There are several reasons for this:

- ***Risk exists only in the future, and it's impossible to know for sure what the future holds. Expectations are often formulated on the basis of what happened in the past, but the events of the past must be taken with a substantial grain of salt.*** *No ambiguity is evident when we view the past. Only the things that happened happened.* ***But that definiteness doesn't mean the process that creates outcomes is clear-cut and dependable. Many things could have happened in each case in the past, and the fact that only one did happen understates the potential for variability that existed.*** *What I mean to say (inspired by Nicolas Nassim Taleb's "Fooled by Randomness") is that the history that took place is only one version of what it could have been. If you accept this, then the relevance of history to the future is much more limited than many believe to be the case. [Along these same lines, Peter Bernstein wrote the following in his November 2001 newsletter: "* ***We like to rely on history to justify our forecasts of the long run, but history tells us over and over again that the unexpected and the unthinkable are the norm, not an anomaly. That is the real lesson of history."]***

- ***Decisions whether or not to bear risk are made in contemplation of normal patterns recurring, and they do most of the time. But once in a while, something very different happens.*** *Or as my friend (and highly skilled investor) Ric Kayne puts it, "Most of financial history has taken place within two standard deviations, but everything interesting has occurred outside of two standard deviations." That's what happened in 2007. We heard all the time that summer, "that was a 5-standard deviation event," or "that was a 10-sigma event," implying it should have happened only once every hundred or thousand or ten thousand years. So how could several such events have happened in a single week, as was claimed in August? The answer is that the improbability of their happening had been overestimated.*

- *Projections tend to cluster around historic norms and call for only small changes. The point is,* ***people usually expect the future to be like the past and underestimate the potential for change****. In August 1996, I wrote a memo showing that in the Wall Street Journal's semi-annual poll of economists, on average the predictions are an extrapolation of the current condition. And when I was a young analyst following Textron, building my earnings estimates based on projections for its four major groups, I invariably found that I had underestimated the extent of both the positive surprises and the shortfalls.*

- ***We hear a lot about "worst-case" projections, but they often turn out not to be negative enough****. What forecasters mean is "bad-case projections." I tell my father's story of the gambler who lost regularly. One day he heard about a race with only one horse in it, so he bet the rent money. Half way around the track, the horse jumped over the fence and ran away. Invariably things can get worse than people expect. Maybe "worst-case" means "the worst we've seen in the past." But that doesn't mean things can't be worse in the future. In 2007, many people's worst-case assumptions were exceeded.*

- ***Risk shows up lumpily****. If we say "2% of mortgages default each year," and even if that's true when we look at a multi-year average, an unusual spate of defaults can occur at a point in time, sinking a structured finance vehicle. Ben Graham and David Dodd put it this way: ". . . the relation between different kinds of investments and the risk of loss is entirely too indefinite, and too variable with changing conditions, to permit of sound mathematical formulation. This is particularly true because investment losses are not distributed fairly evenly in point of time, but tend to be concentrated at intervals . . ." (Security Analysis, 1940 Edition). It's invariably the case that some investors – especially those who employ high leverage – will fail to survive at those intervals.*

- ***People overestimate their ability to gauge risk and understand mechanisms they've never before seen in operation****. In theory, one thing that distinguishes humans from other species is that we can figure out that something's dangerous without experiencing it.* ***We don't have to burn ourselves to know we shouldn't sit on a hot stove. But in bullish times, people tend not to perform this function.*** *Rather than recognize risk ahead, they tend to overestimate their ability to understand how new financial inventions will work.*

- ***Finally and importantly, most people view risk taking primarily as a way to make money.*** *Bearing higher risk generally produces higher returns. The market has to set things up to look like that'll be the case; if it didn't, people wouldn't make risky investments. But it can't always work that way, or else risky investments wouldn't be risky.* ***And when risk bearing doesn't work, it <u>really</u> doesn't work, and people are reminded what risk's all about.***

Most of the time, risk bearing works out just fine. In fact, it's often the case that the people who take the most risk make the most money. However, there also are times when underestimating risk and accepting too much of it can be fatal. ***Taking too little risk can cause you to underperform your peers – but that beats the heck out of the consequences of taking too much risk at the wrong time. No one ever went bankrupt because of an excess of risk consciousness. But a shortage of it – and the imprudent investments it led to – bears responsibility for a lot of what went on in 2007.***

The Many Forms of Risk

The possibility of permanent loss may be the main risk in investing, but it's not the only risk. I can think of lots of other risks, many of which contribute to – or are components of – that main risk.

In the past, in addition to the risk of permanent loss, I've mentioned **the risk of falling short**. Some investors face return requirements in order to make necessary payouts, as in the case of pension funds, endowments and insurance companies. Others have more basic needs, like generating enough income to live on.

Some investors with needs – particularly those who live on their income, and especially in today's low-return environment – face a serious conundrum. **If they put their money into safe investments, their returns may be inadequate. But if they take on incremental risk in pursuit of a higher return, they face the possibility of a still-lower return, and perhaps of permanent diminution of their capital, rendering their subsequent income lower still.** There's no easy way to resolve this conundrum.

There are actually two possible causes of inadequate returns: (a) targeting a high return and being thwarted by negative events and (b) targeting a low return and achieving it. In other words, **investors face not one but two major risks: the risk of losing money and the risk of missing opportunities**. Either can be eliminated but not both. And leaning too far in order to avoid one can set you up to be victimized by the other.

Potential opportunity costs – the result of missing opportunities – usually aren't taken as seriously as real potential losses. But they do deserve attention. **Put another way, we have to consider the risk of not taking enough risk.**

These days, the fear of losing money seems to have receded (since the crisis is all of six years in the past), and the fear of missing opportunities is riding high, given the paltry returns available on safe, mundane investments. Thus a new risk has arisen: **FOMO risk, or the risk that comes from excessive fear of missing out**. It's important to worry about missing opportunities, since people who don't can invest too conservatively. But when that worry becomes excessive, FOMO can drive an investor to do things he shouldn't do and often doesn't understand, just because others are doing them: if he doesn't jump on the bandwagon, he may be left behind to live with envy.

Over the last three years, Oaktree's response to the paucity of return has been to develop a suite of five credit strategies that we hope will produce a 10% return, either net or gross (we can't claim to be more precise than that). I call them collectively the "ten percent solution," after a Sherlock Holmes story called *The Seven-Per-Cent Solution* (we aim to do better). Talking to clients about these strategies and helping them choose between them has required me to focus on their risks.

"Just a minute," you might say, "the ten-year Treasury is paying just 2½% and, as Jeremy Grantham says, the risk-free rate is also return-free. How, then, can you target returns in the vicinity of 10%?" The answer is that it can't be done without taking risk of some kind – and there are several candidates. I'll list below a few risks that we're consciously bearing in order to generate the returns our clients desire:

- Today's ultra-low interest rates imply low returns for anyone who invests in what are deemed safe fixed income instruments. So Oaktree's pursuit of attractive returns centers on accepting and managing **credit risk**, or the risk that a borrower will be unable to pay interest and repay principal as scheduled. Treasurys are assumed to be free of credit risk, and most high grade corporates are thought to be nearly so. **Thus those who intelligently accept incremental credit risk must do so with the expectation that the incremental return promised as compensation will prove sufficient**.

  Voluntarily accepting credit risk has been at the core of what Oaktree has done since its beginning in 1995 (and in fact since the seed was planted in 1978, when I initiated Citibank's high yield bond effort). But bearing credit risk will lead to attractive returns only if it's done well. Our activities are based on two beliefs: (a) that because the investing establishment is averse to credit risk, the incremental returns we receive for bearing it will compensate generously for the risk entailed and (b) that credit risk is manageable – i.e., unlike the general future, credit risk can be gauged by experts (like us) and reduced through credit selection. **It wouldn't make sense to voluntarily bear incremental credit risk if either of these two beliefs were lacking.**

- Another way to access attractive returns in today's low-rate environment is to bear **illiquidity risk** in order to take advantage of investors' normal dislike for illiquidity (superior returns often follow from investor aversion). Institutions that held a lot of illiquid assets suffered considerably in the crisis of 2008, when they couldn't sell them; thus many developed a strong aversion to them and in some cases imposed limitations on their representation in portfolios. Additionally, today the flow of retail money is playing a big part in driving up asset prices and driving down returns. Since retail money has a harder time making its way to illiquid assets, this has made the returns on the latter appear more attractive. It's noteworthy that there aren't mutual funds or ETFs for many of the things we're investing in.

- Some strategies introduce it voluntarily and some can't get away from it: **concentration risk**. "Everyone knows" diversification is a good thing, since it reduces the impact on results of a negative development. But some people eschew the safety that comes with diversification in favor of concentrating their investments in assets or with managers they expect to outperform. And some investment strategies don't permit full diversification because of the limitations of their subject markets. Thus problems – if and when they occur – will be bigger *per se*.

- Especially given today's low interest rates, borrowing additional capital to enhance returns is another way to potentially increase returns. But doing so introduces **leverage risk**. Leverage adds to risk two ways. The first is magnification: people are attracted to leverage because it will magnify gains, but under unfavorable outcomes it will magnify losses instead.

  The second way in which leverage adds to risk stems from **funding risk**, one of the classic reasons for financial disaster. The stage is set when someone borrows short-term funds to make a long-term investment. If the funds have to be repaid at an awkward time – due to their maturity, a margin call, or some other reason – and the purchased assets can't be sold in a timely fashion (or can only be sold at a depressed price), an investment that might otherwise have been successful can be cut short and end in sorrow. Little or nothing may remain of the sale proceeds once the leverage has been repaid, in which case the investor's equity will be decimated. This is commonly called a meltdown. It's the primary reason for the saying, "Never forget the six-foot-tall man who drowned crossing the stream that was five feet deep on average." In times of crisis, success over the long run can become irrelevant.

- **When credit risk, illiquidity risk, concentration risk and leverage risk are borne intelligently, it is in the hope that the investor's skill will be sufficient to produce success. If so, the *potential* incremental returns that appear to be offered as risk compensation will turn into *realized* incremental returns** (per the graphic at the top of page 8). That's the only reason anyone would do these things.

  As the graphic at the bottom of page 8 illustrates, however, investing further out on the risk curve exposes one to a broader range of investment outcomes. In an efficient market, returns are tethered to the market average; in an inefficient market, they're not. **Inefficient markets offer the possibility that an investor will escape from the "gravitational pull" of the market's average return, but that can be either for the better or for the worse**. Superior investors – those with "alpha," or the personal skill needed to achieve outsized returns for a given level of risk – have scope to perform well above the mean return, while inferior investors can come out far below. So hiring an investment manager introduces **manager risk**: the risk of picking the wrong one. It's possible to pay management fees but get decisions that detract from results rather than add.

Some or all of the above risks are potentially entailed in our new credit strategies. Parsing them allows investors to choose among the strategies and accept the risks they're more comfortable with. The process can be quite informative.

Our oldest "new strategy" is Enhanced Income, where we use leverage to magnify the return from a portfolio of senior loans. We think senior loans have the lowest credit risk of anything Oaktree deals with, since they're senior-most among their issuer's debt and historically have produced very few credit losses. Further, they're among our most liquid assets, meaning we face relatively little illiquidity risk, and being active in a broad public market permits us to diversify, reducing concentration risk. Given the relatively high degree of safety stemming from these loans' seniority, returns aren't overly dependent on the presence of alpha, meaning Enhanced Income entails less manager risk than some other strategies. But to have a chance at the healthy return we're pursuing in Enhanced Income requires us to take some risk, and what we're left with is leverage risk. The 3-to-1 leverage in Enhanced Income Fund II will magnify the negative impact of any credit losses (of course we hope there won't be many). However, we're not worried about a meltdown, since the current environment allows us to avoid funding risk; we can (a) borrow for a term that exceeds the duration of the underlying investments and (b) do so without the threat of margin calls related to price declines.

Strategic Credit, Mezzanine Finance, European Private Debt and Real Estate Debt are the other four components of our "ten percent solution."

- All four entail some degree of credit risk, illiquidity risk (they all invest heavily or entirely in private debt) and concentration risk (as their market niches offer only a modest number of investment opportunities, and securing them in today's competitive environment is a challenge).

- The Real Estate Debt Fund can only lever up to 1-to-1, and the other three borrow only small amounts and for short-term purposes, so none of them entails significant leverage risk.

- However, in order to succeed they'll all require a high level of skill from their managers in identifying return prospects and keeping risk under control. Thus they all entail manager risk. Our response is to entrust these portfolios only to managers who've been with us for years.

It's reasonable – essential, really – to study the risk entailed in every investment and accept the amounts and types of risk that you're comfortable with (assuming this can be discerned). It's not reasonable to expect highly superior returns without bearing some incremental risk.

I touched above on concentration risk, but we should also think about the flip side: **the risk of over-diversification**. If you have just a few holdings in a portfolio, or if an institution employs just a few managers, one bad decision can do significant damage to results. But if you have a very large number of holdings or managers, no one of them can have much of a positive impact on performance. Nobody invests in just the one stock or manager they expect to perform best, but as the number of positions is expanded, the standards for inclusion may decline. Peter Lynch coined the term "diworstification" to describe the process through which lesser investments are added to portfolios, making the potential risk-adjusted return worse.

While I don't think volatility and risk are synonymous, there's no doubt that **volatility does present risk**. If circumstances cause you to sell a volatile investment at the wrong time, you might turn a downward fluctuation into a permanent loss. Moreover, even in the absence of a need for liquidity, volatility can prey on investors' emotions, reducing the probability they'll do the right thing. **And in the short run, it can be very hard to differentiate between a downward fluctuation and a permanent loss.** Often this can really be done only in retrospect. Thus it's clear that a professional investor may have to bear consequences for a temporary downward fluctuation simply because of its resemblance to a permanent loss. When you're under pressure, the distinction between "volatility" and "loss" can seem only semantic. Volatility is not "the" definition of investment risk, as I said earlier, but it isn't irrelevant.

One example of a risk connected with volatility – or the deviation of price from what might be intrinsic value – is **basis risk**. Arbitrageurs customarily set up positions where they're long one asset and short a related asset. The two assets are expected to move roughly in parallel, except that the one that's slightly cheaper should make more money for the investor in the long run than the other loses, producing a small net gain with little risk. Because these trades are considered so low in risk, they're often levered up to the sky. But sometimes the prices of the two assets diverge to an unexpected extent, and the equity invested in the trade evaporates. That unexpected divergence is basis risk, and it's what happened to Long-Term Capital Management in 1998, one of the most famous meltdowns of all time. As Long-Term's chairman John Meriwether said at the time, "the Fund added to its positions in anticipation of convergence, yet . . . the trades diverged dramatically." This benign-sounding explanation was behind a collapse some thought capable of bringing down the global financial system.

Long-Term's failure was also attributable to **model risk**. Decisions can be turned over to quants or financial engineers who either (a) conclude wrongly that an unsystematic process can be modeled or (b) employ the wrong model. During the financial crisis, models often assumed that events would occur according to a "normal distribution," but extreme "tail events" occurred much more often than the normal distribution says they will. **Not only can extreme events exceed a model's assumptions, but excessive belief in a model's efficacy can induce people to take risks they would never take on the basis of qualitative judgment**. They're often disappointed to find they had put too much faith in a statistical sure thing.

Model risk can arise from **black swan risk**, for which I borrow the title of Nassim Nicholas Taleb's popular second book. People tend to confuse "never been seen" with "impossible," and the consequences can be dire when something occurs for the first time. That's part of the reason why people lost so much in highly levered subprime mortgage securities. The fact that a nationwide spate of mortgage defaults **hadn't happened** convinced investors that it **couldn't happen**, and their certainty caused them to take actions so imprudent that it **had to happen**.

As long as we're on the subject of things going wrong, we should touch on the subject of **career risk**. As I mentioned in *Dare to Be Great II*, "agents" who manage money for others can be penalized for investments that look like losers (that is, for both permanent losses and temporary downward fluctuations). Either of these unfortunate experiences can result in **headline risk** if the resulting losses are big enough to make it into the media, and some careers can't withstand headline risk. Investors who lack the potential to share commensurately in investment successes face a reward asymmetry that can force them toward the safe end of the risk/return curve. They are likely to think more about the risk of losing money than about the risk of missing opportunities. Thus their portfolios may lean too far toward controlling risk and avoiding embarrassment (and they may not take enough chances to generate returns). There are consequences for these investors, as well as for those who employ them.

Event risk is another risk to worry about, something that was created by bond issuers about twenty years ago. Since corporate directors have a fiduciary responsibility to stockholders but not to bondholders, some think they can (and perhaps should) do anything that's not explicitly prohibited to transfer value from bondholders to stockholders. Bondholders need covenants to shield them from this kind of pro-active plundering, but at times like today it can be hard to obtain strong protective covenants.

There are many ways for an investment to be unsuccessful. The two main ones are **fundamental risk** (relating to how a company or asset performs in the real world) and **valuation risk** (relating to how the market prices that performance). For years investors, fiduciaries and rule-makers acted on the belief that it's safe to buy high-quality assets and risky to buy low-quality assets. But between 1968 and 1973, many investors in the "Nifty Fifty" (the stocks of the fifty fastest-growing and best companies in America) lost 80-90% of their money. Attitudes have evolved since then, and today there's less of an assumption that high quality prevents fundamental risk, and much less preoccupation with quality for its own sake.

On the other hand, investors are more sensitive to the pivotal role played by price. **At bottom, the riskiest thing is overpaying for an asset (regardless of its quality), and the best way to reduce risk is by paying a price that's irrationally low (ditto).** A low price provides a "margin of safety," and that's what risk-controlled investing is all about. **Valuation risk should be easily combatted, since it's largely within the investor's control. All you have to do is refuse to buy if the price is too high given the fundamentals.** "Who wouldn't do that?" you might ask. Just think about the people who bought into the tech bubble.

Fundamental risk and valuation risk bear on the risk of losing money in an individual security or asset, but that's far from the whole story. **Correlation** is the essential additional piece of the puzzle. Correlation is the degree to which an asset's price will move in sympathy with the movements of others. **The higher the correlation among its components, all other things being equal, the less effective diversification a portfolio has, and the more exposed it is to untoward developments.**

An asset doesn't have "a correlation." Rather, it has a different correlation with every other asset. A bond has a certain correlation with a stock. One stock has a certain correlation with another stock (and a different correlation with a third). Stocks of one type (such as emerging market, high-tech or large-cap) are likely to be highly correlated with others within their category, but they may be either high or low in correlation with those in other categories. **Bottom line: it's hard to estimate the riskiness of a given asset, but many times harder to estimate its correlation with all the other assets in a portfolio, and thus the impact on performance of adding it to the portfolio.** This is a real art.

Fixed income investors are directly exposed to another form of risk: **interest rate risk**. Higher interest rates mean lower bond prices – that relationship is absolute. The impact of changes in interest rates on asset classes other than fixed income is less direct and less obvious, but it also pervades the markets. Note that stocks usually go down when the Fed says the economy is performing strongly. Why? The thinking is that stronger economy = higher interest rates = more competition for stocks from bonds = lower stock valuations. Or it might be stronger economy = higher interest rates = reduced stimulus = weaker economy.

One of the reasons for increases in interest rates relates to **purchasing power risk**. Investors in securities (and especially long-term bonds) are exposed to the risk that if inflation rises, the amount they receive in the future will buy less than it could today. This causes investors to insist on higher interest rates and higher prospective returns to protect them against the loss of purchasing power. The result is lower prices.

Finally, I want to mention a new concept I hear about once in a while: **upside risk**. Forecasters are sometimes heard to say "the risk is on the upside." At first this doesn't seem to have much legitimacy, but it can be about the possibility that the economy may catch fire and do better than expected, earnings may come in above consensus, or the stock market may appreciate more than people think. Since these things are positives, there's risk in being underexposed to them.

* * *

To move to the biggest of big pictures, I want to make a few over-arching comments about risk.

The first is that risk is counterintuitive.

- The riskiest thing in the world is the widespread belief that there's no risk.
- Fear that the market is risky (and the prudent investor behavior that results) can render it quite safe.
- As an asset declines in price, making people view it as riskier, it becomes less risky (all else being equal).
- As an asset appreciates, causing people to think more highly of it, it becomes riskier.
- Holding only "safe" assets of one type can render a portfolio under-diversified and make it vulnerable to a single shock.
- Adding a few "risky" assets to a portfolio of safe assets can make it safer by increasing its diversification. Pointing this out was one of Professor William Sharpe's great contributions.

The second is that risk aversion is the thing that keeps markets safe and sane.

- When investors are risk-conscious, they will demand generous risk premiums to compensate them for bearing risk. Thus the risk/return line will have a steep slope (the unit increase in prospective return per unit increase in perceived risk will be large) and the market should reward risk-bearing as theory asserts.
- But when people forget to be risk-conscious and fail to require compensation for bearing risk, they'll make risky investments even if risk premiums are skimpy. The slope of the line will be gradual, and risk taking is likely to eventually be penalized, not rewarded.
- When risk aversion is running high, investors will perform extensive due diligence, make conservative assumptions, apply skepticism and deny capital to risky schemes.

- But when risk tolerance is widespread instead, these things will fall by the wayside and deals will be done that set the scene for subsequent losses.

Simply put, risk is low when risk aversion and risk consciousness are high, and high when they're low.

The third is that risk is often hidden and thus deceptive. Loss occurs when risk – the possibility of loss – collides with negative events. Thus the riskiness of an investment becomes apparent only when it is tested in a negative environment. It can be risky but not show losses as long as the environment remains salutary. The fact that an investment is susceptible to a serious negative development that will occur only infrequently – what I call "the improbable disaster" – can make it appear safer than it really is. Thus after several years of a benign environment, a risky investment can easily pass for safe. That's why Warren Buffett famously said, ". . . you only find out who's swimming naked when the tide goes out."

Assembling a portfolio that incorporates risk control as well as the potential for gains is a great accomplishment. But it's a hidden accomplishment most of the time, since risk only turns into loss occasionally . . . when the tide goes out.

The fourth is that risk is multi-faceted and hard to deal with. In this memo I've mentioned 24 different forms of risk: the risk of losing money, the risk of falling short, the risk of missing opportunities, FOMO risk, credit risk, illiquidity risk, concentration risk, leverage risk, funding risk, manager risk, over-diversification risk, risk associated with volatility, basis risk, model risk, black swan risk, career risk, headline risk, event risk, fundamental risk, valuation risk, correlation risk, interest rate risk, purchasing power risk, and upside risk. And I'm sure I've omitted some. Many times these risks are overlapping, contrasting and hard to manage simultaneously. For example:

- Efforts to reduce the risk of losing money invariably increase the risk of missing out.
- Efforts to reduce fundamental risk by buying higher-quality assets often increase valuation risk, given that higher-quality assets often sell at elevated valuation metrics.

At bottom, it's the inability to arrive at a single formula that simultaneously minimizes all the risks that makes investing the fascinating and challenging pursuit it is.

The fifth is that the task of managing risk shouldn't be left to designated risk managers. I'm convinced outsiders to the fundamental investment process can't know enough about the subject assets to make appropriate decisions regarding each one. All they can do is apply statistical models and norms. But those models may be the wrong ones for the underlying assets – or just plain faulty – and there's little evidence that they add value. In particular, risk managers can try to estimate correlation and tell you how things will behave when combined in a portfolio. But they can fail to adequately anticipate the "fault lines" that run through portfolios. And anyway, as the old saying goes, "in times of crisis all correlations go to one" and everything collapses in unison.

"Value at Risk" was supposed to tell the banks how much they could lose on a very bad day. During the crisis, however, VaR was often shown to have understated the risk, since the assumptions hadn't been harsh enough. Given the fact that risk managers are required at banks and *de rigueur* elsewhere, I think more money was spent on risk management in the early 2000s than in the rest of history combined . . . and yet we experienced the worst financial crisis in 80 years. Investors can calculate risk metrics like VaR and Sharpe ratios (we use them at Oaktree; they're the best tools we have), but they shouldn't put too much faith in them. **The bottom line for me is that risk management should be the responsibility of every participant in the investment process, applying experience, judgment and knowledge of the underlying investments.**

The sixth is that while risk should be dealt with constantly, investors are often tempted to do so only sporadically. Since risk only turns into loss when bad things happen, this can cause investors to apply risk control only when the future seems ominous. At other times they may opt to pile on risk in the expectation that good things lie ahead. But since we can't predict the future, we never really know when risk control will be needed. Risk control is unnecessary in times when losses don't occur, but that doesn't mean it's wrong to have it. The best analogy is to fire insurance: do you consider it a mistake to have paid the premium in a year in which your house didn't burn down?

Taken together these six observations convince me that Charlie Munger's trenchant comment on investing in general – **"It's not supposed to be easy. Anyone who finds it easy is stupid." –** is profoundly applicable to risk management. Effective risk management requires deep insight and a deft touch. It has to be based on a superior understanding of the probability distributions that will govern future events. Those who would achieve it have to have a good sense for what the crucial moving parts are, what will influence them, what outcomes are possible, and how likely each one is. **Following on with Charlie's idea, thinking risk control is easy is perhaps the greatest trap in investing, since excessive confidence that they have risk under control can make investors do very risky things.**

Thus the key prerequisites for risk control also include humility, lack of hubris, and knowing what you don't know. No one ever got into trouble for confessing a lack of prescience, being highly risk-conscious, and even investing scared. Risk control may restrain results during a rebound from crisis conditions or extreme under-valuations, when those who take the most risk generally make the most money. But it will also extend an investment career and increase the likelihood of long-term success. **That's why Oaktree was built on the belief that risk control is "the most important thing."**

Lastly while dealing in generalities, I want to point out that whereas risk control is indispensable, risk avoidance isn't an appropriate goal. The reason is simple: risk avoidance usually goes hand-in-hand with return avoidance. While you shouldn't expect to make money just for bearing risk, you also shouldn't expect to make money without bearing risk.

*   *   *

At present I consider risk control more important than usual. To put it briefly:

- Today's ultra-low interest rates have brought the prospective returns on money market instruments, Treasurys and high grade bonds to nearly zero.
- This has caused money to flood into riskier assets in search of higher returns.
- This, in turn, has caused some investors to drop their usual caution and engage in aggressive tactics.
- And this, finally, has caused standards in the capital markets to deteriorate, making it easy for issuers to place risky securities and – consequently – hard for investors to buy safe ones.

Warren Buffett put it best, and I regularly return to his statement on the subject:

> . . . the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.

While investor behavior hasn't sunk to the depths seen just before the crisis (and, in my opinion, that contributed greatly to it), **in many ways it has entered the zone of imprudence**. To borrow a metaphor from Chuck Prince, Citigroup's CEO from 2003 to 2007, anyone who's totally unwilling to dance to today's fast-paced music can find it challenging to put money to work.

It's the job of investors to strike a proper balance between offense and defense, and between worrying about losing money and worrying about missing opportunity. **Today I feel it's important to pay more attention to loss prevention than to the pursuit of gain**. For the last *four* years Oaktree's mantra has been "move forward, but with caution." At this time, in reiterating that mantra, I would increase the emphasis on those last three words: "but with caution."

Economic and company fundamentals in the U.S. are fine today, and asset prices – while full – don't seem to be at bubble levels. But when undemanding capital markets and a low level of risk aversion combine to encourage investors to engage in risky practices, something usually goes wrong eventually. **Although I have no idea what could make the day of reckoning come sooner rather than later, I don't think it's too early to take today's carefree market conditions into consideration. What I do know is that those conditions are creating a degree of risk for which there is no commensurate risk premium.** We have to behave accordingly.

June 8, 2015 (updating *Risk Revisited* published September 3, 2014)

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Memo to: Oaktree Clients

From: Howard Marks

Re: It's Not Easy

In 2011, as I was putting the finishing touches on my book *The Most Important Thing*, I was fortunate to have one of my occasional lunches with Charlie Munger. As it ended and I got up to go, he said something about investing that I keep going back to: **"It's not supposed to be easy. Anyone who finds it easy is stupid."**

As usual, Charlie packed a great deal of wisdom into just a few words. Let's take the first six: "It's not supposed to be easy." While it's pretty simple to achieve average results, it shouldn't be easy to make superior investments and earn outsized returns. John Kenneth Galbraith said something similar years ago:

> There is nothing reliable to be learned about making money. If there were, study would be intense and everyone with a positive IQ would be rich.

What Charlie and Professor Galbraith meant is this: Everyone wants to make money, and especially to find the sure thing or "silver bullet" that will allow them to do it without commensurate risk. Thus they work hard (actually, study *is* intense), searching for bargain securities and approaches that will give them an edge. They buy up the bargains and apply the approaches. The result is that the efforts of these market participants tend to drive out opportunities for easy money. Securities become more fairly priced, and free lunches become harder to find. **It makes no sense to think it would be otherwise.**

And what about the next seven words: "Anyone who finds it easy is stupid"? It follows from the above that given how hard investors work to find special opportunities, and that their buying eliminates such prospects, **people who think it can be easy overlook substantial nuance and complexity.**

Markets are meeting places where people come together (not necessarily physically) to exchange one thing (usually money) for another. Markets have a number of functions, one of which is to eliminate opportunities for excess returns.

Ed calls me and bids $10,000 for my car. Then he offers to sell it to Bob for $20,000. If Ed's lucky and we both say yes, he doubles his money overnight. To put it simply, anyone who expects to make money easily trading cars this way either thinks (a) Bob and I are idiots or (b) the market won't function in a way that enables us to know about the fair value of my car. If these conditions were met, it would be an "inefficient market."

But if Bob and I have access to market data on used car pricing, Ed's chances of pulling off this deal are greatly reduced. **In most markets, transparency tends to reveal and thus preclude obvious mispricings.** (Thanks to the incredible gains in access to data by way of the Internet, this is certainly more true today than ever before.) **In my view, this is a good part of the basis for Charlie's comment: anyone who thinks it's easy to achieve unusual profits is overlooking the way markets operate. This memo is largely about the challenges they present.**

Second-Level Thinking

I always thought that when I retired, I would write a book pulling together the elements of investment philosophy discussed in my memos. But in 2009, I got an email from Warren Buffett saying that if I'd write a book, he'd give me a blurb for the jacket. It didn't take me long to move up my timing.

Columbia Business School Publishing had been talking to me about a book, and when I told them I was ready, they asked to see a sample chapter. For some reason, I was able to sit down – without previously having given the topic any organized thought – and knock out a chapter about the importance of something I labeled "second-level thinking." This is a crucial subject that has to be understood by everyone who aspires to be a superior investor. And yet I've never covered it explicitly for the readers of my memos. I want to correct that now.

In what ended up being the book's first chapter, I introduced the subject as follows:

> Remember your goal in investing isn't to earn average returns; you want to do better than average. Thus your thinking has to be better than that of others – both more powerful and at a higher level. Since others may be smart, well-informed and highly computerized, you must find an edge they don't have. You must think of something they haven't thought of, see things they miss, or bring insight they don't possess. You have to react differently and behave differently. In short, being right may be a necessary condition for investment success, but it won't be sufficient. You must be more right than others . . . which by definition means your thinking has to be different. . . .
>
> For your performance to diverge from the norm, your expectations – and thus your portfolio – have to diverge from the norm, and you have to be more right than the consensus. Different and better: that's a pretty good description of second-level thinking.

Second-level thinking is what immediately pops into my mind when I think about Charlie's observation. And it's a good general heading under which to discuss the great many things that make superior investing a challenge. **In short, to borrow from Charlie, anyone who thinks it's easy must be a first-level thinker**. Let me use some simple examples from the book to illustrate the difference.

> - First-level thinking says, "It's a good company; let's buy the stock." Second-level thinking says, "It's a good company, but everyone thinks it's a great company, and it's not. So the stock's overrated and overpriced; let's sell."
>
> - First-level thinking says, "The outlook calls for low growth and rising inflation. Let's dump our stocks." Second-level thinking says, "The outlook stinks, but everyone else is selling in panic. Buy!"
>
> - First-level thinking says, "I think the company's earnings will fall; sell." Second-level thinking says, "I think the company's earnings will fall far less than people expect, and the pleasant surprise will lift the stock; buy."
>
> First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first-level thinker needs is an opinion about the future, as in, "The outlook for the company is favorable, meaning the stock will go up."

Second-level thinking is deep, complex and convoluted. The second-level thinker takes many things into account:

- What is the range of likely future outcomes?
- Which outcome do I think will occur?
- What's the probability I'm right?
- What does the consensus think?
- How does my expectation differ from the consensus?
- How does the current price for the asset comport with the consensus view of the future, and with mine?
- Is the consensus psychology that's incorporated in the price too bullish or bearish?
- What will happen to the asset's price if the consensus turns out to be right, and what if I'm right?

The bottom line is that first-level thinkers see what's on the surface, react to it simplistically, and buy or sell on the basis of their reactions. **They don't understand their setting as a marketplace where asset prices reflect and depend on the expectations of the participants. They ignore the part that others play in how prices change. And they fail to understand the implications of all this for the route to success.**

For example, when I lived in Los Angeles, a stockbroker often spoke on the radio station I listened to while driving to work. His advice was simple: "If there's a company whose product you like, buy the stock." That's first-level thinking. How seductively easy. But also how error-prone, in that it ignores the possibility that a company with a good product can have a bad business; the good product can become obsolete; or the stock can be priced too high to be a good investment.

On the other hand, second-level thinkers double-think (and triple-think) every angle of every situation. A good example can be seen in the hypothetical newspaper contest John Maynard Keynes wrote about in 1936. Readers would be shown 100 photos and asked to choose the six prettiest girls, with prizes going to the readers who chose the girls readers voted for most often. Naive entrants would try to win by picking the prettiest girls. **But note that the contest would reward the readers who chose not the prettiest girls, but the most popular.** Thus the road to winning would lie not in figuring out which were the prettiest, but in predicting which girls the average entrant would consider prettiest. Clearly, to do so, the winner would have to be a second-level thinker. (The first-level thinker wouldn't even recognize the difference.)

Wikipedia points out that one vying to win the contest might go beyond this distinction:

> This can be carried one step further to take into account the fact that other entrants would each have their own opinion of what public perceptions are. Thus the strategy can be extended to the next order and the next and so on, at each level attempting to predict the eventual outcome of the process based on the reasoning of other agents.
>
> "It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees." (Keynes, *The General Theory of Employment, Interest and Money,* 1936).

Keynes created his contest to make a point about the stock market. In the short run, beating the market requires the ability to predict which stocks will win the popularity contest among investors. Higher-level thinkers who recognize this dynamic have a head start toward earning the greatest gains. Ben Graham applied the same thinking when he described the market as a "voting machine" in the short run (although he made plain his belief that it's a "weighing machine" in the long run).

The first-level thinker simply looks for the highest-quality company, the best product, the fastest earnings growth or the lowest p/e ratio. He's ignorant of the very existence of a second level at which to think, and of the need to pursue it.

The second-level thinker goes through a much more complex process when thinking about buying an asset. Is it good? Do others think it's as good as I think it is? Is it really as good as I think it is? Is it as good as others think it is? Is it as good as others think others think it is? How will it change? How do others think it will change? How is it priced given: its current condition; how I think its condition will change; how others think it will change; and how others think others think it will change? And that's just the beginning. No, this isn't easy.

(Please note that the above discussion is entirely on the subject of short-term investing, and I go through it only to provide a graphic illustration of the difference between first-level and second-level thinking. Oaktree and I aren't focused on short-term results, and the thinking we apply to long-run considerations is quite different. We think much less about what others will make popular in the short run; instead, we rely on the eventual functioning of the weighing machine. The highest priority – by far – should be an objective evaluation of fundamentals. Market participants can get so caught up in predicting other participants' behavior that they ignore value and fail to buy bargains out of fear that the assets in question will remain unpopular or become more so. This creates great opportunities for those investors whose willingness to think independently and endure the short-term pain that comes with temporary unpopularity enables them to purchase attractive investments from the bargain counter.)

What Keynes's hypothetical contest shows most clearly is that the route to success in the competitive arena may not be what it seems at first glance. When the goal is to lift the greatest weight, achieve the lowest score on the golf course, get the highest grade on a math test or finish a crossword puzzle in the shortest time, the competition is against oneself and the objective challenge at hand. But when the goal, as it is in investing, is to outdo other people in a largely mental pursuit involving a lot of psychology – while they're trying to do the same to you – the challenge is much more complex.

The investor's basic goal of buying desirable assets at fair prices is sensible and straightforward. But the deeper you look, the more you see how many aspects of successful investing are counterintuitive and how much of what seems obvious is wrong. There's a lot more that matters, of course, but these realizations are key.

<u>The Things Everyone Likes</u>

The most outstanding characteristic of first-level thinkers – and of the investing herd – is that they like things with obvious appeal. These are the things that are easy to understand and easy to buy. But that's unlikely to be the path to investment success. Here's how I put it in "Everyone Knows" (April 2007):

What's clear to the broad consensus of investors is almost always wrong.

First, most people don't understand the process through which something comes to have outstanding moneymaking potential. And second, the very coalescing of popular opinion behind an investment tends to eliminate its profit potential.

Take, for example, the investment that "everyone" believes to be a great idea. In my view by definition it simply cannot be so.

- If everyone likes it, it's probably because it has been doing well. Most people seem to think outstanding performance to date presages outstanding future performance. Actually, it's more likely that outstanding performance to date has borrowed from the future and thus presages sub-par performance from here on out.

- If everyone likes it, it's likely the price has risen to reflect a level of adulation from which relatively little further appreciation is likely. (Sure it's possible for something to move from "overvalued" to "more overvalued," but I wouldn't want to count on it happening.)

- If everyone likes it, it's likely the area has been mined too thoroughly – and has seen too much capital flow in – for many bargains to remain.

- If everyone likes it, there's significant risk that prices will fall if the crowd changes its collective mind and moves for the exit.

Superior investors know – and buy – when the price of something is lower than it should be. And the price of an investment can be lower than it should be only when most people don't see its merit. Yogi Berra is famous for having said, "Nobody goes to that restaurant anymore; it's too crowded." It's just as nonsensical to say, "Everyone realizes that investment's a bargain." If everyone realizes it, they'll have bought, in which case the price will no longer be low.

So the things with the most obvious merit become the things that everyone likes. They're also likely to be the things that are most hotly pursued and most highly priced, and thus least promising and most treacherous. What are some examples?

When I first showed up for work in First National City Bank's investment research department in 1968, the bank was investing heavily in the "Nifty Fifty": the stocks of America's best, fastest growing companies. Since these were companies where nothing could go wrong, the official dictum said it didn't matter much what price you paid. It didn't seem unreasonable to pay p/e ratios of 80 or 90 given these companies' growth rates.

But it turned out that the price you pay does matter, and 80-90 times earnings had been too high. Thus, when the market ran into trouble in the early 1970s, many of these stocks lost the vast majority of their value, and investors learned the hard way that it's possible to like a good thing too much. Unsurprisingly, it also turned out that predictions of a flawless future can be wrong, as once-dominant companies such as Kodak, Polaroid and Xerox eventually went bankrupt or required turnarounds.

Roughly ten years ago, everyone was gaga over real estate, especially residential. This was underpinned by some bits of "accepted wisdom" that seemed compelling, such as "you can always live in it," "home prices always go up" and "real estate is a hedge against inflation." Conservative debt investors (rather than buyers of homes themselves) were persuaded to buy levered and tranched mortgage-backed securities by the fact that "there has never been a nationwide wave of mortgage defaults."

But in 2007 it turned out that home prices can go down as well as up, and mortgage loans extended casually based on their flawless record can have flaws. Homes and mortgages, bought when everyone liked them, turned out to be terrible investments.

The fact is, painful bubbles can't come into existence if there isn't an underlying grain of truth. The Nifty Fifty *were* generally terrific companies. Home prices *do* tend to rise over time and offset inflation. Mortgages generally *are* repaid or carry adequate collateral. The Internet *would* change the world. Oil at $147/barrel *was* indispensable and in short supply. But in each case the merits were too obvious; the investment ideas became too popular; and asset prices consequently became dangerously high.

Following the trends that are popular at a point in time certainly isn't a formula for investment success, since popularity is likely to lead investors on a path that is comfortable but pointed in the wrong direction. Here's more from "Everyone Knows":

> The fact is, there is no dependable sign pointing to the next big moneymaker: a good idea at a too-low price. Most people simply don't know how to find it. . . .
>
> Large amounts of money (and by that I mean unusual returns, or unusual risk-adjusted returns) aren't made by buying what everybody likes. They're made by buying what everybody underestimates.
>
> In short, there are two primary elements in superior investing:
>
> - seeing some quality that others don't see or appreciate (and that isn't reflected in the price), and
> - having it turn out to be true (or at least accepted by the market).
>
> **It should be clear from the first element that the process has to begin with investors who are unusually perceptive, unconventional, iconoclastic or early. That's why successful investors are said to spend a lot of their time being lonely.**

<u>Risk and Counterintuitiveness</u>

If what's obvious and what everyone knows is usually wrong, then what's right? The answer comes from inverting the concept of obvious appeal. The truth is, the best buys are usually found in the things most people don't understand or believe in. These might be securities, investment approaches or investing concepts, but the fact that something isn't widely accepted usually serves as a green light to those who're perceptive (and contrary) enough to see it. A great example can be found in the area of risk (again from "Everyone Knows"):

> **"I wouldn't buy that at any price – everyone knows it's too risky."** That's something I've heard a lot in my life, and it has given rise to the best investment opportunities I've participated in. In fact, to an extent, it has provided the foundation for my career. In the 1970s and 1980s, insistence on avoiding non-investment grade bonds kept them out of most institutional portfolios and therefore cheap. Ditto for the debt of bankrupt companies: what could be riskier?

> **The truth is, the herd is wrong about risk at least as often as it is about return.** A broad consensus that something's too hot to handle is almost always wrong. Usually it's the opposite that's true.
>
> **I'm firmly convinced that investment risk resides most where it is least perceived, and vice versa:**
>
> - When everyone believes something is risky, their unwillingness to buy usually reduces its price to the point where it's not risky at all. Broadly negative opinion can make it the least risky thing, since all optimism has been driven out of its price.
>
> - And, of course, as demonstrated by the experience of Nifty Fifty investors, when everyone believes something embodies no risk, they usually bid it up to the point where it's enormously risky. No risk is feared, and thus no reward for risk bearing – no "risk premium" – is demanded or provided. That can make the thing that's most esteemed the riskiest.
>
> **This paradox exists because most investors think quality, as opposed to price, is the determinant of whether something's risky.** But high-quality assets can be risky, and low-quality assets can be safe. It's just a matter of the price paid for them.

For me, it follows from the above that the bottom line is simple: **the riskiest thing in the world is the widespread belief that there's no risk**. That's what most people believed in 2006-07, and that belief abetted the careless behavior that brought on the Great Financial Crisis. Only an understanding that risk was high could have discouraged that behavior and rendered the world safe.

I call this "the perversity of risk." For most people it's hard to grasp that a perception of safety brings on risk, and a perception of risk can lead to safety. But it's clear for the deeper second-level thinker. This is just another example of the fact that what "everyone knows" is what shapes the environment, bringing high prices when things are perceived to be good, and vice versa.

A perception that fundamental risk is low and the future is positive causes investors to be optimistic. This, in turn, causes asset prices to rise, and thus investment risk to be high. **The problem that befalls most people – the first-level thinkers – is that they fail to distinguish between fundamental risk and investment risk.**

What has to be remembered is the defining role of price. Regardless of whether the fundamental outlook is positive or negative, the level of investment risk is determined largely by the relationship between the price of an asset and its intrinsic value. There is no asset so good that it can't become overpriced and thus risky, and few so bad that there's no price at which they're a buy (and safe). **This is one of the greatest examples of counterintuitiveness. Only those who are able to see its logic can hope to be superior investors.**

What Else?

I've covered a few of the most important topics under the headings of complexity and counter-intuitiveness:

- the importance of second-level thinking,
- the lack of identity between "good company" and "good investment,"
- the unhelpfulness of the things everyone knows, and
- the perversity of risk.

I see, however, that I've already filled seven pages. So rather than continue to provide a full treatment of all the topics I want to cover, let's conduct an exercise. I'll list below a number of elements of time-honored investment wisdom. See if you can tell which are helpful and which aren't:

- The market is "efficient," meaning asset prices reflect all available information and thus provide accurate estimates of intrinsic value.
- Because people are risk-averse, risky deals are discouraged and the market awards appropriate risk premiums as compensation for incremental risk.
- Risky investments produce high returns.
- Adding risky assets to a portfolio makes it riskier.
- It's desirable that everything in a well-diversified portfolio performs well.
- Understanding the science of economics will enable you to safely harness the macro future.
- Sometimes the outlook is clear, and sometimes it's complicated and unpredictable. You have to be careful when it's the latter.
- Correct forecasts lead to investment gains.
- A forecast has to be correct in order to be profitable.
- The earning of a profit proves the investor made a good decision.
- A low price makes for an attractive investment.
- Assets that are appreciating deserve your attention.
- Contrarianism will bring consistent success.
- It's important to do what feels right.
- Assets with greater liquidity are safer.
- The level of risk in a portfolio can be kept low by applying a simple formulaic process.

My answer is that all sixteen reflect potential misconceptions, and they have to be (a) understood at the second level, not the first, and (b) dismissed as always holding the keys to success. Here's why:

- **The market is "efficient," meaning asset prices reflect all available information and thus provide accurate estimates of intrinsic value** – The efficient market hypothesis assumes people are rational and objective. But since emotion so often rules in place of reason, the market doesn't necessarily reflect what's true, but rather what investors think is true. Thus prices can range all over the place. Sometimes they're fair, but sometimes they're way too high or low. It's a big mistake to impute rationality to the market and believe its message.

- **Because people are risk-averse, risky deals are discouraged and the market awards appropriate risk premiums as compensation for incremental risk** – The truth is that investors' risk-averseness fluctuates between too much and too little. When it's the latter, skepticism and conservatism dry up, due diligence is inadequate, risky deals are easy to pull off, and compensation for risk bearing usually turns out to be insufficient. **Investors absolutely cannot depend on the market to discipline itself.**

- **Risky investments produce high returns** – This is one of the greatest of the old saws, and one of the wrongest.

  - A collection of low-risk investments can produce a high return if the low-risk character of the components permits them to perform dependably and keeps there from being any big losers to pull down the overall result. An absence of losses can give you a great start toward a good outcome. **This is the cornerstone of Oaktree's investment philosophy.**

  - On the other hand, high-risk investments can't be counted on for high returns. If they could, they wouldn't be high-risk. High-risk investments can fail to provide the high returns they seemed to promise if the analysis underlying them proves to have been ill-founded or if they run into negative developments.

  The presumed positive relationship between risk and return is predicated on the assumption that there's no such thing as investment skill and value-adding decision making. If markets are efficient and there's no skill, it's reasonable to believe that higher returns can be attained only through the bearing of increased risk. **But if outstanding skill is present, there's no reason to think it can't be used to create portfolios with low risk *and* high return potential.**

- **Adding risky assets to a portfolio makes it riskier** – One of Nobel prize-winner William Sharpe's greatest contributions to investment theory came in the realization that if a portfolio holds only low-risk assets, the addition of a risky asset can make it safer. This happens because doing so increases the portfolio's diversification and reduces the correlation among its components, reducing its vulnerability to a single negative development.

- **It's desirable that everything in a well-diversified portfolio performs well** – The truth is, if all the holdings were to perform well in one scenario, they could all perform poorly in another. That means the benefits of diversification wouldn't be enjoyed. It shouldn't be surprising – or totally disappointing – to have some laggards in a portfolio that's truly well-diversified.

- **Understanding the science of economics will enable you to safely harness the macro future** – There are no immutable rules in play. "In economics and investments, because of the key role played by human nature, you just can't say for sure that 'if A, then B,' as you can in real science. The weakness of the connection between cause and effect makes outcomes uncertain. In other words, it introduces risk." ("Risk Revisited," September 2014).

- **Sometimes the outlook is clear, and sometimes it's complicated and unpredictable. You have to be careful when it's the latter** – The truth is, the future is never worry-free. Sometimes it seems to be, because no risks are apparent. But the skies are never as clear as they seem at their clearest. **Which is more treacherous: when everyone understands that the future presents risks, or when they believe it to be knowable and benign? As I mentioned earlier, I worry about the latter much more than the former.**

- **Correct forecasts lead to investment gains** – The easiest way to have a correct forecast is to extrapolate a trend and see it continue as expected. Most forecasters do a lot of extrapolating, meaning their forecasts are usually broadly shared. Thus when the trend does continue, everyone's right. But since everyone held the same view, the continuing trend was probably discounted in advance in the price of the asset, and the fact that it rolls on as expected doesn't necessarily produce profit. For a forecast to be highly profitable, it has to be idiosyncratic. But, given how often trends continue, idiosyncratic forecasts aren't often right.

- **A forecast has to be correct in order to be profitable** – Just as correct forecasts aren't necessarily profitable, profitable forecasts don't have to be correct. A forecast – even if it's not correct – can be profitable if it's merely less wrong than others. If a trend that everyone else extrapolates turns out not to continue, a prediction of the deviation can be very profitable . . . even if it's not exactly on target.

- **The earning of a profit proves the investor made a good decision** – One of the first things I learned at Wharton was that you can't necessarily tell the quality of a decision from the outcome. Given the unpredictability of future events and, especially, the presence of randomness in the world, a lot of well-reasoned decisions produce losses, and plenty of poor decisions are profitable. Thus one good year or a few big winners may tell us nothing about an investor's skill. We have to see a lot of outcomes and a long history – and especially a history that includes some tough years – before we can say whether an investor has skill or not.

- **A low price makes for an attractive investment** – I talked at the bottom of page seven about the importance of price in determining whether an investment is risky. But if you reread the part in bold, you'll see it doesn't say a low price is the essential element. An asset may have a low absolute dollar price, a low price compared to the past, or a low p/e ratio, but usually the price has to be low relative to the asset's intrinsic value for the investment to be attractive and for the risk to be low. **It's easy for investors to get into trouble if they fail to understand the difference between cheapness and value.**

- **Assets that are appreciating deserve your attention** – Most people impute intelligence to the market, and thus they think rising prices signal fundamental merit. They may be attracted to "momentum investing," which is based on the belief that something that has been appreciating is likely to continue doing so. But the truth is, the higher the price (everything else being equal), the less attractive an asset is. Momentum investing works until it stops, at which time the things that have been doing worst – and may be most undervalued – take over market leadership.

- **Contrarianism will bring consistent success** – It's true that the investing herd is often wrong. In particular, it behaves more aggressively the more prices rise, and more cautiously the more they fall – the opposite of what should happen. But doing the opposite of what the crowd does isn't a sure thing either. Much of the time there isn't anything dramatic to either do or avoid. Contrarianism is most effective at the extremes, and then only for those who understand what the herd is doing and why it's wrong. And they still have to summon the nerve to do the opposite.

- **It's important to do what feels right** – The best investors know intellectually what the right thing to do is. But while this knowledge gives them comfort, they have to tamp down their feelings in order to follow it. The best ideas are ones others haven't tumbled to, and as I wrote in "Dare to Be Great," "Non-consensus ideas have to be lonely. By definition, non-consensus ideas that are popular, widely held or intuitively obvious are an oxymoron. . . . **Most great investments begin in discomfort." Good investors are subjected to the same misleading influences and emotions as everyone else. They're just more capable of keeping them under control.**

- **Assets with greater liquidity are safer** – Greater liquidity generally means you can get out of an asset easier and closer to the price of the last trade. But first, liquidity can dry up when other investors change their mind about the asset. And second, the theoretical ability to get out when you want says nothing about fundamental safety and relatively little about investment safety in the long run. It's much safer to be in well-analyzed assets with good fundamentals and attractive prices, in which case you can hold for a long time without needing to exit. The best defense against a lack of liquidity is arranging your affairs so there's little need for it.

- **The level of risk in a portfolio can be kept low by applying a simple formulaic process** – Rather, risk comes in many forms and they can be overlapping, contrasting and hard to manage. For example, as I said in "Risk Revisited," efforts to reduce the risk of losing money invariably increase the risk of missing out on gains, and efforts to reduce fundamental risk by buying higher-quality assets often increase valuation risk, given that higher-quality assets often sell at elevated valuation metrics.

What does the above consist of? It's a collection of time-honored bromides that range from (a) only effective part of the time to (b) just plain wrong. These investment myths are pervasive but of little help. That fact leaves the investor to struggle in a complex, challenging environment.

Recent Experience

The recent volatility in the world's markets, the S&P 500's 11% drop between August 17 and 25, and the decline of nearly 40% in Chinese equities have given investors an opportunity to experience something else that's not easy: portfolio management under adverse conditions. A few lessons are worth noting, none of which are always easy to employ:

- Emotion is one of the investor's greatest enemies. Fear makes it hard to remain optimistic about holdings whose prices are plummeting, just as envy makes it hard to refrain from buying the appreciating assets that everyone else is enjoying owning. As I mentioned just above, everyone is buffeted by the same influences and emotions. **Superior investors may not be insulated, but they manage to act as if they are.**

- Confidence is one of the key emotions, and I attribute a lot of the market's recent volatility to a swing from too much of it a short while ago to too little more recently. **The swing may have resulted from disillusionment: it's particularly painful when investors recognize that they know far less than they had thought about how the world works.** In this case, when China's growth slowed, its currency depreciated and its market corrected, I think a lot of investors realized they don't know what the implications of these things are for the economies of the U.S. and the world. It's important to remain moderate as to confidence, but instead it's usually the case that confidence – like other emotions – swings radically.

- Especially during downdrafts, many investors impute intelligence to the market and look to it to tell them what's going on and what to do about it. **This is one of the biggest mistakes you can make. As Ben Graham pointed out, the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously.** Market participants have limited insight into what's really happening in terms of fundamentals, and any intelligence that could be behind their buys and sells is obscured by their emotional swings. It would be wrong to interpret the recent worldwide drop as meaning the market "knows" tough times lay ahead. Rather, China came out with some negative news and people panicked, especially

Chinese investors who had bought stocks on margin and perhaps were experiencing their first serious market correction. Their selling prompted investors in the U.S. and elsewhere to sell also, believing that the market decline in China signaled serious implications for the Chinese economy and others. **The analysis of fundamentals and valuation should dictate an investor's behavior, not the actions of others. If you let the investing herd – which determines market movements – tell you what to do, how can you expect to outperform?**

- While China was the "proximate cause" of the volatility, other things often contribute, and last month was no exception. The word that always comes to mind for me is "confluence." **Investors can usually keep their heads in the face of one negative. But when they face more than one simultaneously, they often lose their cool.** One additional negative last month was the glitch in Bank of New York Mellon's SunGard software, and the bank's consequent inability to price 1,200 mutual funds and ETFs that it administers. It was another dose of disillusionment: no one enjoys learning that the market mechanisms they need to work can't be depended on.

- In good times – perhaps emulating Warren Buffett – investors talk about how much they'd like to see the stocks they own decline in price, since it would allow them to add to positions at lower levels. **But when prices collapse, the chance to average down is usually a lot less welcome . . . and a lot harder to act on.**

- Investors can be tempted to sell during corrections like this one. Oftentimes emotional behavior is cloaked in intelligent-sounding rationalizations like "it's important to sell down to your comfort level." But the valid reasons to sell are principally because you feel fundamentals have deteriorated or because the price has risen enough. **Selling to get more comfortable as prices fall (just like buying for that purpose in a rising market) has nothing to do with the relationship between price and value.**

- Another reason to sell, of course, is fear that the slide will continue. But if you're tempted to do so, ask yourself first whether you think the stock market is going to rise or fall tomorrow, and second how much you'd bet on it. If you can tackle those decisions in your head rather than your gut, you'll probably admit you have no idea what's going to happen in the short term.

- Regardless of the outlook for fundamentals or the relationship between price and value, many people sell in a downdraft because, well, you have to do something, and they feel it's unreasonably passive to just sit there. **But something about which I feel strongly is that it's not the things you buy and sell that make you money; it's the things you hold.** Of course you have to buy things in order to hold them. But my point is that transactions merely adjust what you own, and engaging in them doesn't necessarily increase potential profit. Sticking with what you own may be enough – although it may not be easy in tough times.

- In my memo on liquidity in March, I borrowed an idea from my son Andrew: If you look longingly at the chart for a stock that has risen for twenty years, think about how many days there were when you would've had to talk yourself out of selling. That's not always easy. Two of the main reasons people sell stocks are because they go up and because they go down. When they go up, people who hold them become afraid that if they don't sell, they'll give back their profit, kick themselves, and be second-guessed by their bosses and clients. And when they go down, they worry that they'll fall further.

There may be absolutely no intellectual justification for that feeling. If you liked it a month ago at $80, should you sell it now just because it's at $60? **The best way to get through a downdraft is to verify your thesis, tighten your seatbelt and hang on. If you sell just because there's a downdraft (or an updraft), you'll never get that twenty-year winner.** When you look closely, you'll see that every twenty-year rise included a lot of ups and downs. To enjoy long-term success, you have to hold through them.

- A lot has been written of late about reduced liquidity in the current investment environment, in part a result of restrictions under the Volcker rule. This may have contributed to last month's volatility, but it should be viewed as having exacerbated the short-term pain, not as altering the long-term fundamentals.

Coping with a declining market seems easy ahead of time, since emotions aren't in play and investors know what they should do. It's only when prices start falling in earnest, as they have recently, that it turns out to be harder than expected.

So What Will Work?

Superior investing isn't easy. I've set forth a number of examples of its complexity, and a long list of simplistic rules that can't be depended on. Among the many things that keep investing from being easy is the fact that no tactic works every time. Almost every tool an investor might employ is a two-edged sword. Here's how I put it last year in "Dare to Be Great II":

- If you invest, you will lose money if the market declines.
- If you don't invest, you will miss out on gains if the market rises.

- Market timing will add value if it can be done right.
- Buy-and-hold will produce better results if timing can't be done right.

- Aggressiveness will help when the market rises but hurt when it falls.
- Defensiveness will help when the market falls but hurt when it rises.

- If you concentrate your portfolio, your mistakes will kill you.
- If you diversify, the payoff from your successes will be diminished.

- If you employ leverage, your successes will be magnified.
- If you employ leverage, your mistakes will be magnified.

Each of these pairings indicates symmetry. None of the tactics listed will add value if it's right but not subtract if it's wrong. Thus none of these tactics, in and of itself, can hold the secret to dependably above average investment performance.

There's only one thing in the investment world that isn't two-edged, and that's "alpha": superior insight or skill. Skill can help in both up markets and down markets. And by making it more likely that your decisions are right, superior skill can increase the expected benefit from concentration and leverage. But that kind of superior skill by definition is rare and elusive. . . .

> **Why should superior profits be available to the novice, the untutored or the lazy?** Why should people be able to make above average returns without hard work and above average skill, and without knowing something most others don't know? And yet many individuals invest based on the belief that they can. (If they didn't believe that, wouldn't they index or, at a minimum, turn over the task to others?)
>
> No, the solution can't lie in rigid tactics, publicly available formulas or loss-eliminating rules . . . or in complete risk avoidance. **Superior investment results can only stem from a better-than-average ability to figure out when risk taking will lead to gain and when it will end in loss.** There is no alternative.

Superior skill is an essential ingredient if superior investment results are to be achieved reliably. **No tactic or technique will lead to superior results in the absence of superior judgment and implementation.** But by definition, only a small percentage of investors possess superior skill.

It is mathematically irrefutable that (a) the average investor will produce before-fee performance in line with the market average and (b) active management fees will pull the average investor's return below the market average. This has to be considered in light of the fact that average performance can generally be obtained through passive investing, with tiny fees and almost no risk of falling short.

Superior investors and their well-thought-out approaches can produce superior returns on average in the long run. But even they are far from perfect. The best they can hope for is that they'll be right more often than they're wrong, and that their successful decisions will add more than their mistakes subtract.

So, in the end, there's only one absolute truth about investing. Charlie's right: it isn't easy.

September 9, 2015

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Memo to: Oaktree Clients

From: Howard Marks

Re: Inspiration from the World of Sports

I'm constantly intrigued by the parallels between investing and sports. They're illuminating as well as fun, and thus they've prompted two past memos: "How the Game Should Be Played" (May 1995) and "What's Your Game Plan?" (September 2003). In the latter memo, I listed five ways in which investing is like sports:

- It's competitive – some succeed and some fail, and the distinction is clear.
- It's quantitative – you can see the results in black and white.
- It's a meritocracy – in the long term, the better returns go to the superior investors.
- It's team-oriented – an effective group can accomplish more than one person.
- It's satisfying and enjoyable – but much more so when you win.

Another angle on the investing/sports analogy has since occurred to me: an investment career can feel like a basketball or football game with an unlimited number of quarters. We may be nearing December 31 with a substantial year-to-date return or a big lead over our benchmarks or competitors, but when January 1 rolls around, we have to tackle another year. Our record isn't finalized until we leave the playing field for good. Or as Yogi Berra put it, "It ain't over till it's over." It was Yogi's passing in late September that inspired this memo. [Since most of the references in this memo are to American sports, with their peculiarities and unique terminology, this is a good time for an apology to anyone who's unfamiliar with them.]

Yogi Berra, Baseball Player

Lawrence "Yogi" Berra was a catcher on New York Yankees baseball teams for eighteen years, from 1946 to 1963. Although he was rarely number one in any offensive category, he often ranked among the top ten players in runs batted in, home runs, extra-base hits (doubles, triples and home runs), total bases gained and slugging percentage (total bases gained per at bat). He excelled even more on defense: in the 1950s he was regularly among the top three or four catchers in terms of putouts, assists, double plays turned, stolen bases allowed and base stealers thrown out.

Yogi was selected to play in the All-Star Game every year from 1948 through 1962. He was among the top three vote-getters for American League Most Valuable Player every year from 1950 through 1956, and he was chosen as MVP in three of those years. The Yankee teams on which he played won the American League pennant and thus represented the league in the World Series fourteen times, and they won the World Series ten times. He was an important part of one of the greatest dynasties in the history of sports.

To me, the thing that stands out most is Yogi's consistency. Not only did he perform well in so many different categories, but also:

- He led the American League in number of games played at the grueling catcher position eight years in a row.

- He was regularly among the catchers with the fewest passed balls and errors committed.
- He had around 450-650 at bats most years, but over his entire career he averaged only 24 strikeouts per year, and there was never one in which he struck out more than 38 times. (In 1950 he did so only 12 times in nearly 600 at bats.) Thus, ten times between 1948 and 1959 he was among the ten players with the fewest strikeouts per plate appearance.

In short, Yogi rarely messed up.

Consistency and minimization of error are two of the attributes that characterized Yogi's career, and they can also be key assets for superior investors. They aren't the only ways for investors to excel: some great ones strike out a lot but hit home runs in bunches the way Reggie Jackson did. Reggie – nicknamed "Mr. October" because of his frequent heroics in the World Series – was one of the top home run hitters of all time. But he also holds the record for the most career strikeouts, and his ratio of strikeouts to home runs was four times Yogi's: 4.61 versus 1.16. **Consistency and minimization of error have always ranked high among my priorities and Oaktree's, and they still do.**

Yogi Berra, Philosopher

Although Yogi was one of the all-time greats, his baseball achievements may be little-remembered by the current generation of fans, and few non-sports lovers are aware of them. He's probably far better known for the things he said:

- It's like déjà vu all over again.
- When you come to a fork in the road, take it.
- You can observe a lot by just watching.
- Always go to other people's funerals, otherwise they won't come to yours.
- I knew the record would stand until it was broken.
- The future ain't what it used to be.
- You wouldn't have won if we'd beaten you.
- I never said most of the things I said.

I've cited Yogi's statements in previous memos, and I borrowed the Yogi-ism at the top of the list above for the title of one in 2012. "Out of the mouths of babes," they say, comes great wisdom. The same was true for this uneducated baseball player, and many of Yogi's seeming illogicalities turn out to be profound upon more thorough examination.

"Baseball is ninety percent mental and the other half is physical." That was another of Yogi's dicta, and I think it's highly useful when thinking about investing. Ninety percent of the effort to outperform may consist of financial analysis, but you need to put another fifty percent into understanding human behavior. **The market is made up of people, and to beat it you have to know them as well as you do the thing you're considering investing in.**

I sometimes give a presentation called, "The Human Side of Investing." Its main message surrounds just that: while investing draws on knowledge of accounting, economics and finance, it also requires insight into psychology. Why? Because investors' objectivity and rationality rarely prevail as much as investment theory assumes, and emotion and "human nature" often take over instead. That's why my presentation is subtitled, **"In theory there's no difference between theory and practice. In practice there is."** Yogi said that, too, and I think it's absolutely wonderful.

Things often fail to work the way investment theory says they should. Markets are supposed to be efficient, with no underpricings to find or overpricings to avoid, making it impossible to outperform. But exceptions arise all the time, and they're usually attributable more to human failings than to math mistakes or overlooked data.

And that leads me to one of the most thought-provoking Yogi-isms, concerning his choice of restaurant: "Nobody goes there anymore because it's too crowded." What could be more nonsensical? If nobody goes there, how can it be crowded? And if it's crowded, how can you say nobody goes there?

But as I wrote last month in "It's Not Easy," a lot of accepted investment wisdom makes similarly little sense. And perhaps the greatest – and most injurious – of all is the near-unanimous enthusiasm that's behind most bubbles.

"Everyone knows it's a great buy," they say. That, too, makes no sense. **If everyone believes it's a bargain, how can it not have been bought up by the crowd and had its price lifted to non-bargain status as a result?** You and I know the things all investors find desirable are unlikely to represent good investment opportunities. But aren't most bubbles driven by the belief that they do?

- In 1968, everyone knew the Nifty Fifty stocks of the best companies in America represented compelling value, even after their p/e ratios had reached 80 or 90. That belief kept them there . . . for a while.

- In 2000, everyone thought tech investing was infallible and tech stocks could only rise. And they were sure the Internet would change the world and the stocks of Internet companies were good buys at any price. That's what took the TMT boom to its zenith.

- And here in 2015, everyone knows social media companies will own the future. But will their valuations turn out to be warranted?

Logically speaking, the bargains that everyone has come to believe in can't still be bargains . . . but that doesn't stop people from falling in love with them nevertheless. Yogi was right in indirectly highlighting the illogicality of "common knowledge." **As long as people's reactions to things fail to be reasonable and measured, the spoils will go to those who are able to recognize this contradiction.**

<u>Looking for Lance Dunbar</u>

There may be a few folks in America who, like the rest of the world's population, are unaware of the growing popularity of daily fantasy football. In this on-line game, contestants assemble imaginary football teams staffed by real professional players. When that week's actual football games are played, the participants receive "fantasy points" based on their players' real-world accomplishments, and the participants with the most points win cash prizes. (Why is it okay to engage in interstate betting on fantasy football but not on football itself? Because proponents were able to convince the authorities that the act of picking a team for fantasy football qualifies it as a game of skill, not chance. But last week, Nevada became the sixth state to ban daily fantasy sports, concluding that it's really nothing but gambling.) **The commercials for fantasy football say things like, "Sign up, make your picks, and collect your winnings." That sounds awfully easy . . . and not that different from discount brokers' ads during bull markets.**

In daily fantasy football, the challenge comes from the fact that the participants have a limited amount of money to spend and want to acquire the best possible team for it. **If all players were priced the same**

regardless of their ability (a completely inefficient market), the prize would go to the participant who's most able to identify talented players. And if all players were priced precisely in line with their ability (a completely efficient market), it would be impossible to acquire a more talented team for the same budget, so winning would hinge on random developments.

The market for players in fantasy football appears to be less than completely efficient. Thus participants have the possibility of finding mispricings. A star may be overpriced, so that he produces few fantasy points per dollar spent on him. And a journeyman might be underpriced, able to produce more rushing (i.e., running) yards, catches, tackles or touchdowns than are reflected by his price. That's where the parallel to investing comes in.

Smart fantasy football participants understand that the goal isn't to acquire the best players, or players with the lowest absolute price tags, but players whose "salaries" understate their merit – those who are underpriced relative to their potential and might amass more points in the next game than the cost to draft them reflects**. Likewise, smart investors know the goal isn't to find the best companies, or stocks with the lowest absolute dollar prices or p/e ratios, but the ones whose potential isn't fully reflected in their price. In both of these competitive arenas, the prize goes to those who see value others miss.**

There's another similarity. Sports media employ "experts" to cover this imaginary football league, and it's their job to attract viewers and readers by offering advice on which players to draft. (What other talking heads does that remind you of?) My musings on fantasy football started in late September, when I heard a TV commentator urge that participants take a look at Lance Dunbar, a running back for the Dallas Cowboys, based on the belief that Dunbar's price might understate his potential to earn fantasy points. The commentator's thesis was that the Cowboys' star quarterback was injured and, because of the replacement quarterback's playing style, Dunbar might get more opportunities – and run up more yardage – than his price implied. Thus, Dunbar might represent an underappreciated investment opportunity.

Or not. Dunbar tore his anterior cruciate ligament in the next game, meaning he won't produce any more points – real or virtual – this season. It just proves that even if your judgment is sound, randomness has a lot of influence on outcomes. You never know which way the ball will bounce.

"Sign up, make your picks, and collect your winnings." If only everyone – fantasy football entrants and investors alike – understood it's not that easy.

<u>Are the Helpers Any Help?</u>

In investing, there are a lot of people who'll offer to enhance your results . . . for a fee. In an allegorical treatment in Berkshire Hathaway's 2005 annual report, Warren Buffett called them "Helpers." There are helpers in sports, too, especially where there's betting. This memo gives me a chance to discuss an invaluable clipping on the subject that I collected nine months ago and have been looking for an occasion to mention.

The *New York Post*'s sports writers opine weekly as to which professional football games readers should bet on (real games, not fantasy). Each week, the *Post* reports on the results of the prognostications for the season to date. When they published the results last December 28, they might have thought they demonstrated the value of those helpers. But I think that tabulation – nearly at the end of the football season – showed something very different.

By the time December 28 had rolled around, the eleven forecasters had tried to predict the winner of each of the 237 games that had been played to date, as well as what they thought were their 47 or so "best bets." By "the winner," I assume they meant the team that would win net of the bookies' "point spread." (Without doing something to even the odds, it would be too easy for bettors to win by backing the favorites. To make betting more of a challenge, the bookies establish a spread for each game: the number of points by which the favored team has to beat the underdog in order to be deemed the winner for betting purposes.) How often were the *Post*'s picks correct? Here's the answer:

Percentage correct	Total picks (2,607 games)	Best bets (522 games)
All forecasters	50.9%	49.4%
Median forecaster	50.6	47.9
Best forecaster	58.5	56.2
Worst forecaster	44.8	39.6

An incorrigible optimist – or perhaps the *Post* – might say these results show what a good job the forecasters did as a group, since some were right more often than they were wrong. But that's not the important thing. For me, the key conclusions are these:

- The average results certainly make it seem that picking football winners (net of the points spread) is just a 50/50 proposition. Evidently, the folks who establish the point spreads are pretty good at their job, so that it's hard to know which team will win.

- The symmetrical distribution of the results and the way they cluster around 50% tell me there isn't much skill in predicting football winners (or, if it exists, these pickers don't have it). The small deviations from 50% – both positive and negative – suggest that picking winning football teams for betting purposes may be little more than a matter of tossing a coin.

- Even the best forecasters weren't right much more than half the time. While I'm not a statistician, I doubt the fact that a few people were right on 56-58% of their picks rather than 50% proves it was skill rather than luck. Going back to the coin, if you flipped one 47 times (or even 237 times), you might occasionally get 58% heads.

- **Lastly, all eleven writers collectively – and seven of them individually – had worse results on the games they considered their "best bets" than on the rest of the games.** So clearly they aren't able to accurately assess the validity of their own forecasts.

And remember, these forecasts weren't made by members of the general populace, but rather by people who make their living following and writing about sports.

My favorite quotation on the subject of forecasts comes from John Kenneth Galbraith: "We have two classes of forecasters: Those who don't know – and those who don't know they don't know." Clearly these forecasters don't know. But do they know it? And do their readers?

The bottom line on picking football winners seems to be that the average forecaster is right half the time, with exceptions that are relatively few in number, insignificant in degree and possibly the result of luck. He might as well flip a coin. **And that brings us back to investing, since I find this analogous to the**

observation that the average investor's return equals the market average. He, too, might as well flip a coin . . . or invest in an index fund.

And by the way, the average participant's average result – in both fields – is before transaction costs and fees. **After costs, the average investor's return is below that of the market. In that same vein, after costs the average football bettor doesn't break even.**

What costs? In sports betting, we're not talking about management fees or brokerage commissions, but "vigorish" or "the vig." Wikipedia says it's "also known as *juice*, the *cut* or the *take* . . . the amount charged by a bookmaker . . . for taking a bet from a gambler." This obscure term refers to the fact that to try to win $10 from a bookie, you have to put up $11. You're paid $10 if you win, but you're out $11 if you lose. N.b.: bookies and sports betting parlors aren't in business to provide a public service.

If you bet against a friend and win half the time, you end up even. But if you bet against a bookie or a betting parlor and win half the time, on average you lose 10% of the amount wagered on every other bet. So at $10 per game, a bettor following the *Post*'s football helpers through December 28, 2014 would have won $13,280 on the 1,328 correct picks but lost $14,069 on the 1,279 losers. Overall, he would have lost $789 even though slightly more than half the picks were right. **That's what happens when you play in a game where the costs are high and the edge is insufficient or non-existent.**

<u>Another Look at Performance Assessment</u>

This memo gives me an opportunity to touch on another recent sporting event: Super Bowl XLIX, which was played last February. I'm returning to a subject I covered at length in the "What's Real?" section in "Pigweed" (February 2006), which was about the meltdown of a hedge fund called Amaranth. Among the ways I tried to parse the events surrounding Amaranth was through an analogy to the Rose Bowl game played at the end of the 2005 college football season to determine the national champion. In the game, the University of Texas beat the favored University of Southern California. While leading by five points with less than three minutes left to play, USC had a fourth down with two yards to go for a first down. They lost largely because – in something other than the obvious choice – the coach elected to go for it rather than punt the ball away, and they were stopped a yard short. UT got the ball and went on to score the winning touchdown. Before the game, USC had widely been considered one of the greatest teams in college football history. Afterwards there was no more talk along those lines. Its loss hinged on that one very controversial play . . . controversial primarily because it was unsuccessful. (Had USC made the two yards and earned a first down, they would have retained the ball and been able to run out the clock, sealing a victory.)

Something very similar happened in this year's Super Bowl. The Seattle Seahawks were trailing the New England Patriots by a few points. On second down, with just 26 seconds to go and one timeout remaining, the Seahawks had the ball on the Patriots' one-yard line. Everyone was sure they would try a run by Marshawn Lynch (who in the regular season had ranked first in the league in rushing touchdowns and fourth in rushing yards), and that he would score the winning touchdown. But the Seahawks' maverick coach, Pete Carroll – ironically, also the coach of USC's losing Rose Bowl team – tried a pass play instead. The Patriots intercepted the pass, and the Seahawks' dreams of a championship ended.

"What an idiot Carroll is," the fans screamed. "Everyone knows that when you throw a pass, only three things can happen (it's caught, it's dropped or it's intercepted) and two of them are bad." The Seahawks lost a game they seemed to be on the verge of winning, and Carroll was vilified for being too bold and wrong . . . again. **His decision was unsuccessful. But was it wrong?**

With assistance from Warren Min in Oaktree's Real Estate Department, I want to point out some of the considerations that Carroll may have taken into account in making his decision:

- Up to that point in the season, more than 100 passes had been attempted from the one-yard line, and none of them had been intercepted. So Carroll undoubtedly expected that, at the very worst, the pass would be incomplete and the clock would stop (as it does after incomplete passes) with just a few seconds elapsed. That would have given the Seahawks time for one or two more plays.

- With only 26 seconds remaining and the Seahawks down to their last timeout, if they ran and Lynch was stopped, the clock would have kept running (as it does after rushing plays). Seattle would then have been forced to either use their precious timeout or try a hurried play.

- Malcolm Butler, the defender who intercepted Seattle's pass, was a rookie playing in the biggest game of his life, and he was undersized relative to Ricardo Lockette, the wide receiver to whom the pass was thrown.

- According to *The Boston Globe*, of Lynch's 281 carries during the 2014 regular season, 20 had resulted in lost yardage and two more had yielded fumbles. In other words, the Seahawks had experienced a setback 7.8% of the time when Lynch carried the ball. Further, Lynch had been handed the ball at the one-yard line five times in 2014, but he scored only once, for a success rate of 20%. Thus it was no sure thing that Lynch would be able to gain that needed yard against a defense expecting him to run.

To the first-level thinker, Carroll's decision to pass looks like a clear mistake. Maybe that's because great running backs seem so dependable, or because passing generally seems like an uncertain proposition. Or maybe it's just because the pass was picked off and the game lost: outcomes strongly bias perceptions.

The second-level thinker sees that the obvious call – to run – was far from sure to work, and that doing the less-than-obvious – passing – might put the element of surprise on the Seahawks' side and represent better clock management. Carroll made his decision and it was unsuccessful. But that doesn't prove he was wrong.

Here's what my colleague Warren wrote me:

> The media and "talking heads" completely buried the decision to throw because of one data point: the pass was intercepted and the Seahawks lost the game. But I don't believe this was a bad decision. In fact, I think this was a very well-informed decision that more people possessing all the data might have made given ample time to analyze the situation.
>
> As you always say, you can't judge the quality of a decision based on results. If we somehow were able to replay this game in alternative realities to test the results, I think the Seahawks' decision wouldn't look so bad. But they certainly lost, perhaps because of bad luck. Now, similar to the USC/Texas situation, the media has written some very significant storylines regarding legacies:
>
> - The Patriots secured "dynasty" status by winning four Super Bowls since 2001.
> - Tom Brady, the Patriots' quarterback, is hailed as one of the greatest of all time.
> - The Seahawks' defense, which was talked about as being "the greatest ever," is lauded no more (despite the fact that it wasn't defense that lost the game).

But should this one victory – which swung on a single play – really place the Patriots and Tom Brady among the greatest? And was Carroll actually wrong? All of this goes back to one of my favorite themes from *Fooled by Randomness* by Nassim Nicholas Taleb, for me the bible on how to understand performance in an uncertain world.

In his book, Taleb talks about "alternative histories," which I describe as "the other things that reasonably could have happened but didn't." Sure, the Seahawks lost the game. But they could have won, and Carroll's decision would have made the difference in that case, too, making him the hero instead of the goat. **So rather than judge a decision solely on the basis of the outcome, you have to consider (a) the quality of the process that led to the decision, (b) the *a priori* probability that the decision would work (which is very different from the question of whether it <u>did</u> work), (c) the other decisions that could have been made, (d) all of the events that reasonably could have unfolded, and thus (e) which of the decisions had the highest probability of success.**

Here's the bottom line:

- There are many subtle but logical reasons for arguing that Coach Carroll's decision made sense.
- The decision would have been considered a stroke of genius if it had been successful.
- Especially because of the role of luck, the correctness of a decision cannot necessarily be judged from the outcome.
- You clearly cannot assess someone's competence on the basis of a single trial.

What all the above really illustrates is the difference between superficial observation and deep, nuanced analysis. **The fact that something worked doesn't mean it was the result of a correct decision, and the fact that something failed doesn't mean the decision was wrong. This is at least as true in investing as it is in sports.**

<u>The Victor's Mindset</u>

It often seems that just as I'm completing a memo, a final inspiration pops up. This past weekend, the *Financial Times* carried an interesting interview with Novak Djokovic, the number one tennis player in the world today. What caught my eye was what he said about the winner's mental state:

> I believe that half of any victory in a tennis match is in place before you step on the court. **If you don't have that self-belief, then fear takes over.** And then it will get too much for you to handle. It's a fine line. (Emphasis added)

Djokovic's statement reminded me of a conversation I had earlier this month, on a subject I've written about rarely if ever: self-confidence. It ranks high among the attributes that must be present if one is to achieve superior results.

To be above average, an athlete has to separate from the pack. To win at high-level tennis, a player has to hit "winners" – shots his opponents can't return. They're hit so hard, so close to the lines or so low over the net that they have the potential to end up as "unforced errors." In the absence of skill, they're unlikely to be executed successfully, meaning it's unwise to try them. But people who possess the requisite skill are right in attempting them in order to "play the winner's game" (see "What's Your Game Plan").

These may be analogous to investment actions that Yale's David Swensen would describe as "uncomfortably idiosyncratic." The truth is, most great investments begin in discomfort – or, perhaps better said, they involve doing things with which most people are uncomfortable. To achieve great performance you have to believe in value that isn't apparent to everyone else (or else it would already be reflected in the price); buy things that others think are risky and uncertain; and buy them in amounts large enough that if they don't work out they can lead to embarrassment. What are examples of actions that require self-confidence?

- Buying something at $50 and continuing to hold it – or maybe even buying more – when the price falls to $25 and "the market" is telling you you're wrong.
- After you've bought something at $50 (thinking it's worth $200), refusing to "prudently take some chips off the table" when it gets to $100.
- Going against conventional wisdom and daring to "catch a falling knife" when a company defaults and the price of its debt plummets.
- Buying much more of something you like than it represents in the index you're measured against, or entirely excluding an index component you dislike.

In each of these cases, the first-level thinker does that which is conventional and easy – and which doesn't require much self-confidence. The second-level thinker views things differently and, as a consequence, is willing to take actions like those described above. **But they're unlikely to be done in the absence of conviction.** The great investors I know are confident second-level thinkers and entirely comfortable diverging from the herd.

It's great for investors to have self-confidence, and it's great that it permits them to behave boldly, **but only when that self-confidence is warranted. This final qualification means that investors must engage in brutally candid self-assessment.** Hubris or over-confidence is far more dangerous than a shortage of confidence and a resultant unwillingness to act boldly. That must be what Mark Twain had in mind when he said, "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." **And it also has to be what Novak Djokovic meant when he said, "It's a fine line."**

So there you have some of the key lessons from sports:

- For most participants, success is likely to lie more dependably in discipline, consistency and minimization of error, rather than in bold strokes – high batting average and an absence of strikeouts, not the occasional, sensational home run.
- But in order to be superior, a player has to do something different from others and has to have an appropriate level of confidence that he can succeed at it. Without conviction he won't be able to act boldly and survive bouts of uncertainty and the inevitable slump.
- Because of the significant role played by randomness, a small sample of results is far from sure to be indicative of talent or decision-making ability.
- The goal for bettors is to see value in assets that others haven't yet recognized and that isn't reflected in prices.
- At first glance it seems effort and "common sense" will lead to success, but these often prove to be unavailing.
- In particular, it turns out that most people can't see future outcomes much better than anyone else, but few are aware of this limitation.
- Before a would-be participant enters any game, he should assess his chances of winning and whether they justify the price to play.

These lessons can serve investors very well.

October 22, 2015

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Memo to: Oaktree Clients

From: Howard Marks

Re: On the Couch

I woke up early on Saturday, December 12 – the morning after a day of significant declines in stocks, credit and crude oil – with enough thoughts going through my mind to keep me from going back to sleep. Thus I moved to my desk to start a memo that would pull them together. I knew it might be a long time between inception and eventual issuance, since every time I dealt with one thought, two more popped into my head. In the end, it took a month to get it done.

Professor Richard Thaler of the University of Chicago is a leading expert on behavioral economics and decision-making (in fact, he's such a significant figure in the field that he was given a cameo role in the movie *The Big Short*). He opens his new book, *Misbehaving*, with Vilfredo Pareto's assertion that "the foundation of political economy and, in general, of every social science, is evidently psychology." I'd apply that equally to the not-so-scientific field of investing.

It has been one of my constant refrains – dating back all the way to "Random Thoughts on the Identification of Investment Opportunities" (January 1994) – **that in order to be successful, an investor has to understand not just finance, accounting and economics, but also psychology**. A thorough understanding of how investors' minds work is essential if one is to figure out where a market is in its cycle, why, and what to do about it. For me, the markets' recent behavior – certainly on December 11, but also at other points in 2015 – reinforces that observation.

This memo is my attempt to send the markets to the psychiatrist's couch, and an exploration of what might be learned there.

2012-14: An Uncertain World

In September 2012, I wrote a memo called "On Uncertain Ground." To begin it, I observed that "The world seems more uncertain today than at any other time in my life." I went on to list the things that worried me. Few of them are less troubling today. Certainly the period of the post-crisis recovery hasn't been carefree. Here are the things that concerned me in 2012, as viewed from that perspective:

- **Macro growth** – It seems to be broadly accepted that overall economic growth will be slower in the years ahead than in the latter part of the twentieth century. Do lower birth rates and slowing gains in productivity doom us to reduced macro gains? What does this mean for everything else? In particular, if growth remains slow, will it lead to slowing inflation, or even deflation?
- **Trends in the developed world** – Will the developed nations be able to compete in a globalized economy? How will incomes hold up as developing nations produce goods cheaper, and as the quality of those goods improves? As we increasingly become knowledge-based economies, will we need as many less-educated workers as in the past? If not, what will be the ramifications for unemployment, income inequality and society as a whole?
- **Consumer behavior** – Will consumers regain the confidence required to return to their expansive spending behavior? Will they employ credit as in the past to perpetuate growth in consumption?

- **Europe** – Will Europe move forward in terms of cohesion, coordination and productivity? What happens if it doesn't? Will the ECB be able to engineer an economic recovery? Will the departure from the European Union of Greece – or new Greeces – return as a worry in the future? (And now, will the coming referendum mandate Great Britain's departure? Will there be a new referendum in Scotland with regard to remaining in the UK? Will Catalonia vote to leave Spain, and what will that mean for its membership in the EU?)
- **Leadership** – For years I gave speeches using PowerPoint slides listing sources of uncertainty, but where it was supposed to say "dearth of leadership," someone had mistakenly typed "death of leadership" . . . and nobody quibbled. Throughout the world, few countries if any have leaders on par with history's best. Certainly that's true in the U.S. You may think it's a good thing, or you may not, but it's clear that Washington is too gridlocked to accomplish much. As I wrote in "On Uncertain Ground," ". . . U.S. politicians seem to value things like 'ideological purity' (i.e., toeing the party line) and being reelected above real attempts at problem solving. Partisanship and open warfare has surely reached a new zenith."
- **Entitlements** – Social Security is a locomotive rumbling down the track to ruin. The cost of health care programs is growing rapidly, as drugs become more expensive and Americans live longer. Defined-benefit pensions have been promised to public employees but not fully funded. How will federal, state and city governments meet their obligations? Not only does no one know, but also few people in government (certainly not in Washington) seem to care.
- **China** – As the world's second-largest economy, China plays a very important role in determining global growth. Its GDP advanced at double-digit rates over the last 20+ years – without recessions – on the basis of (a) millions of people moving from farms to cities (and to more productive roles in manufacturing), (b) the low-cost exports they produced and (c) readily available capital and the heavy fixed-asset investment it permitted. Henceforth China will gain less from the above and will have to transition to domestic consumption of goods and services, as well as a slower-growing economy . . . perhaps with ups and downs like the rest of the world. Will this result in a near-term hard landing? And what will be the impact on nations that sell commodities and finished goods to China?
- **Geopolitical hotspots** – From the fall of the Soviet Union at the end of 1991 until the 9/11 attacks in 2001, investors' positive feelings were abetted by the presence of peace in the world. But in recent years we have faced challenges involving Iran, Israel and the rest of the Middle East; Russia and Ukraine; China and North Korea; and terrorist threats in many places. How will markets react to the inevitable flare-ups?

The worries listed above confronted investors throughout the period 2012 through 2014. And in the last few months of that period, we saw a halving of the price of oil; additional slowing in China; worsening news from the Middle East; and continuing uncertainty regarding the Fed's likely action on interest rates.

Given markets' abhorrence of uncertainty, we normally would expect such issues to result in low asset prices and negative returns. But in 2012-14, despite the many negatives, we saw a cumulative return of 74% on the S&P 500, as well as strong appreciation on the part of real estate and companies that had been the subject of buyouts. Further reflecting investor confidence, the yield spread versus Treasurys for the average U.S. high yield bond narrowed from 706 basis points at the end of 2011 to 522 b.p. at the end of 2014, at which point the prospective yield to worst was down to 6.67%. Thus, as 2014 moved to a close, we saw:

- the litany of meaningful macro risks described above,
- investors engaging in pro-risk behavior in pursuit of adequate returns in a low-return world,
- as a consequence, full asset prices, and thus
- little likelihood of achieving returns high enough to compensate for the risks.

To sum up, psychology (and thus prices) were high given the fundamentals. Our world was marked by low prospective returns and plentiful problems, a troubling combination.

Here's what I wrote in "Risk Revisited" in September 2014:

> While investor behavior hasn't sunk to the depths seen just before the crisis (and, in my opinion, that contributed greatly to it), in many ways it has entered the zone of imprudence. . . .
>
> It's the job of investors to strike a proper balance between offense and defense, and between worrying about losing money and worrying about missing opportunity. Today I feel it's important to pay more attention to loss prevention than to the pursuit of gain. For the last three years Oaktree's mantra has been "move forward, but with caution." At this time, in reiterating that mantra, I would increase the emphasis on those last three words: "but with caution". . . .
>
> Although I have no idea what could make the day of reckoning come sooner rather than later, I don't think it's too early to take today's carefree market conditions into consideration. What I do know is that those conditions are creating a degree of risk for which there is no commensurate risk premium.

The Negatives Build

Given the many concerns, performance in the first half of 2015 was sluggish at best. Most markets eked out positive returns, but gains came grudgingly, and few investors had a good time. Then, during the summer, the accumulation of worries accelerated and became too much to withstand:

- Growth remained flat or slowed in the U.S., Europe and Japan.
- China's economy continued to slow.
- The Fed continued to dither regarding interest rates. A potential increase caused worry, but so did the appearance that the Fed considered growth too weak to allow an increase.
- The oil price decline resumed, and other metals and commodities joined in, weakening the prices of related stocks and bonds.
- The geopolitical picture went from bad to worse:
    - Syria presented a choice between (a) enabling a despot to remain and (b) ousting him and turning over another country to instability and insurgency.
    - Russia intervened, flexing its muscles and reminding us of its intransigence.
    - ISIS and the flow of immigrants to Europe took on the appearance of insoluble problems; Paris and San Bernardino showed terrorism to be a serious ongoing threat.
    - An agreement was reached to limit Iran's nuclear progress, but no two experts seemed to agree on whether it was a good or bad thing.
    - Iraq, Afghanistan, Israel and Palestine got no better.
    - The South China Sea heated up from time to time.
- There was nothing positive to say about the U.S. political situation. Partisanship and gridlock remained the rule. The grinding two-year campaign took up increased airtime and mindshare, without a positive consensus concerning most candidates.
- Finally, a number of issues internal to the markets – ranging from reduced liquidity to market-reporting glitches to the meltdown of high-risk credit funds – shook investors' faith.

Somehow, market participants are able to live with uncertainties like these and retain their equanimity, sometimes for long periods. **Maybe it's conviction, maybe it's obliviousness, and maybe it's denial.** And that's what prevailed in recent times; as Doug Kass put it in mid-2014, we've been experiencing "a bull market in complacency."

But eventually something else happens – perhaps the house of cards grows too high – and investors' feeling of serenity is pierced. A point is reached beyond which equanimity can no longer be maintained. It was getting to that point that led to meaningful declines in U.S. credit markets in the latter half of 2015.

The Tipping Point

One of the most notable behavioral traits among investors is their tendency to overlook negatives or understate their significance for a while, and then eventually to capitulate and overreact to them on the downside. I attribute a lot of this to psychological failings and the rest to the inability to appreciate the true significance of events.

As negatives accumulate – whether they surface for the first time or just are finally recognized as significant – eventually a time comes when they can no longer be ignored, and instead they come to be treated as being of overwhelming importance. The latest tipping point was reached last August.

Up to that point, investors had pretty much resisted the negatives, and the S&P 500 was up 3.3% in the first seven months of the year. (The media might say investors had "coped with" the negatives, but of course they hadn't dealt with them; they'd ignored them.)

But then, in August, a series of negatives occurred in China: reports of still more economic slowing; a decline in A-share prices from June to August that reached 45%; an unexpected devaluation of the renminbi (whose value many people complained for years had been artificially depressed); and market-support measures that some found ham-handed (e.g., restrictions on actions such as short selling, and investigations of journalists writing negative articles about the stock market).

"Everyone knew" for years that the Chinese economy had been overstimulated with cheap financing, and that this had led to excessive investment in fixed assets. The effect was exceptional GDP growth, but also a large stock of unneeded buildings and infrastructure. Everyone also knew that a hard landing – a painful slowing in economic growth, and perhaps a recession – was among the possible outcomes. **But it wasn't until August that investors outside China began to notice A-shares' collapse; consider the possibility that a slowdown in China could have negative ramifications for the rest of the world; and import those worries to their own markets.** Thus between August 17 and 25, the S&P 500 declined 11%. What was behind the extrapolation of China's woes to other markets, like ours? Here's how I explained it in "It's Not Easy," published in September on the heels of the events in China:

> Especially during downdrafts, many investors impute intelligence to the market and look to it to tell them what's going on and what to do about it. **This is one of the biggest mistakes you can make. As Ben Graham pointed out, the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously.** Market participants have limited insight into what's really happening in terms of fundamentals, and any intelligence that could be behind their buys and sells is obscured by their emotional swings. It would be wrong to interpret the recent worldwide drop as meaning the market "knows" tough times lay ahead. Rather, China came out with some negative news and people panicked, especially Chinese investors who had

bought stocks on margin and perhaps were experiencing their first serious market correction. Their selling prompted investors in the U.S. and elsewhere to sell also, believing that the market decline in China signaled serious implications for the Chinese economy and others.

Whatever the reason, the bottom line for me is that whereas risk tolerance had ruled through July, risk aversion was reawakened in August. I picture an investor who's oblivious to risk in the earlier months and then suddenly says, "Oh yeah: there are things to worry about." **The tipping point finally arrives, a sudden wake-up call to the existence and importance of risk.**

<u>Half-Full or Half-Empty?</u>

Almost 25 years ago, in my second memo ("First Quarter Performance," April 1991), I introduced the concept of the investment pendulum:

> Although the midpoint of its arc best describes the location of the pendulum "on average," it actually spends very little of its time there. Instead, it is almost always swinging toward or away from the extremes of its arc. But whenever the pendulum is near either extreme, it is inevitable that it will move back toward the midpoint sooner or later.

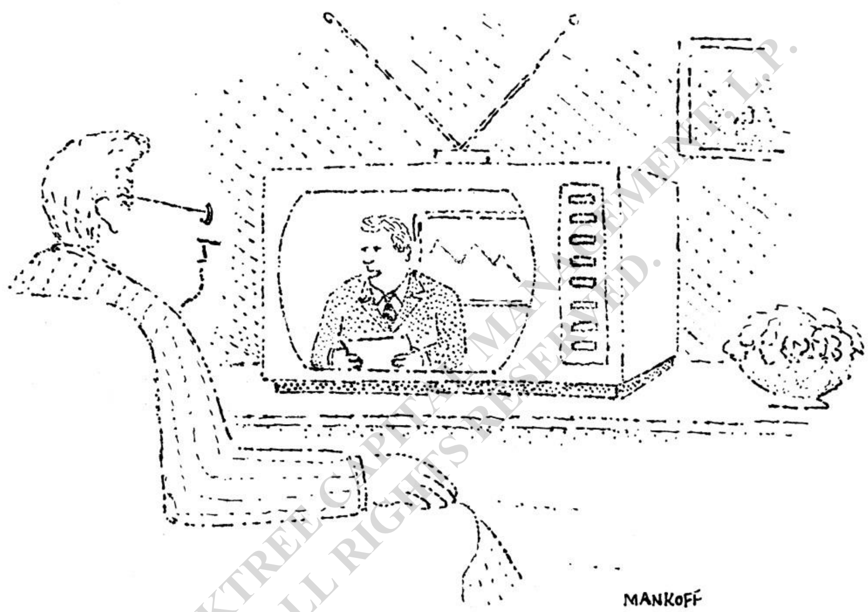
One of the most significant factors keeping investors from reaching appropriate conclusions is their tendency to assess the world with emotionalism rather than objectivity. Their failings take two primary forms: selective perception and skewed interpretation. In other words, sometimes they take note of only positive events and ignore the negative ones, and sometimes the opposite is true. And sometimes they view events in a positive light, and sometimes it's negative. But rarely are their perceptions and interpretations balanced and neutral.

Ever since the August events in China, I've repeatedly found myself harking back to one of the oldest cartoons in my file, and still one of the very best:

"Everything that was good for the market yesterday is no good for it today."

In 2015 we saw old problems get worse, new ones arise, and a general absence of anything to feel good about. The sense of hopelessness regarding problems like ISIS and runaway immigration is something investors handle particularly poorly. In August, the events in China sparked a revival of risk aversion and fear, with effects that carried around the world for a couple of weeks. And with the door opened to fearful interpretation, Pollyanna tolerance gave way to widespread negativism.

The bottom line is that investor psychology rarely gives equal weight to both favorable and unfavorable developments. Likewise, investors' interpretation of events is usually biased by their emotional reaction to whatever is going on at the moment. Most developments have both helpful and harmful aspects. But investors generally obsess about one or the other rather than consider both. And that recalls another classic cartoon:



"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."

It all seems so obvious: investors rarely maintain objective, rational, neutral and stable positions. **First they exhibit high levels of optimism, greed, risk tolerance and credulousness, and their resulting behavior causes asset prices to rise, potential returns to fall and risk to increase. But then, for some reason – perhaps the arrival of a tipping point – they switch to pessimism, fear, risk aversion and skepticism, and this causes asset prices to fall, prospective returns to rise and risk to decrease.** Notably, each group of phenomena tends to happen in unison, and the swing from one to the other often goes far beyond what reason might call for.

That's one of the crazy things: in the real world, things generally fluctuate between "pretty good" and "not so hot." But in the world of investing, perception often swings from "flawless" to "hopeless." The pendulum careens from one extreme to the other, spending almost no time at "the happy medium" and rather little in the range of reasonableness. **First there's denial, and then there's capitulation.**

The Sources of Error

To explain why these bipolar episodes occur, I want to spend a little time on some of the factors behind investor psychology. For the most part they're easily observed and dissected, and not mysterious. I discussed some of them in "It's Not Easy":

> Emotion is one of the investor's greatest enemies. Fear makes it hard to remain optimistic about holdings whose prices are plummeting, just as envy makes it hard to refrain from buying the appreciating assets that everyone else is enjoying owning. Confidence is one of the key emotions, and I attribute a lot of the market's recent volatility to a swing from too much of it a short while ago to too little more recently. **The swing may [result] from disillusionment: it's particularly painful when investors recognize that they know far less than they had thought about how the world works.** It's important to remain moderate as to confidence, but instead it's usually the case that confidence – like other emotions – swings radically.
>
> While China was the "proximate cause" of the recent volatility, other things often contribute, and last month was no exception. The word that always comes to mind for me is "confluence." **Investors can usually keep their heads in the face of one negative. But when they face more than one simultaneously, they often lose their cool.** One additional negative last month was the glitch in Bank of New York Mellon's SunGard software, and the bank's consequent inability to price 1,200 mutual funds and ETFs that it administers. It was another dose of disillusionment: no one enjoys learning that the market mechanisms they need to work can't be depended on.

Another area of error – be it the result of flawed perception or inadequate insight and analysis – can be seen in investors' repeated failure to understand the potential for ramifications and second-order consequences. One instance was the general lack of concern about contagion from sub-prime mortgage backed securities that prevailed between early 2007 – when mortgages began to default in large numbers – and the tumultuous events of mid/late 2008. Most people overlooked the potential for contagion, and thus (for example), as of May 2008 the S&P 500 was essentially unchanged from the first quarter of 2007. Yet sub-prime mortgage defaults contributed significantly to the subsequent bank collapses and bailouts, the bankruptcy filing of Lehman Brothers, and the late-2008 emergence of fear of a financial system meltdown. As a consequence, between May 2008 and March 2009 the S&P lost 52%. **The events that produced such extreme distress in late 2008 and early 2009 were unforeseen and unimagined just a few months before . . . even though the clues had been there for a year.**

There are many more ways in which non-objective, non-rational quirks commonly affect behavior. As Carol Tavris points out in her May 15, 2015 *Wall Street Journal* review of Professor Thaler's book:

> As a social psychologist, I have long been amused by economists and their curiously delusional notion of the "rational man." Rational? Where do these folks live? Even 50 years ago, experimental studies were demonstrating that people stay with clearly wrong decisions rather than change them, throw good money after bad, justify failed predictions rather than admit they were wrong, and resist, distort or actively reject information that disputes their beliefs.

The difficulty of understanding events, their significance and their potential ramifications comes in good part from the kinks in investors' psyches, and it contributes to – and feeds back to exacerbate – investors' responses. Thus investors tend to emphasize just the positives or the negatives much more often than they take a balanced, objective approach. And they tend to become optimistic and eager to buy when good news, positively interpreted, has forced prices up . . . and vice versa. All of this is obvious (especially in retrospect), and thus equally obviously, understanding and dealing with it presents a potential way to improve results.

Notions of market efficiency – the idea that most assets are priced "right" – are based on belief in investor rationality and objectivity. But certainly those traits are little seen in real life. "Inefficiencies" – in everyday language, "mispricings" – stem from biases against one asset or in favor of another: legal, cultural, informational, and especially behavioral and emotional. The first three of these exist much less nowadays than they did 30 or 40 years ago, but the latter two still rear their head from time to time. And I'm sure they always will.

<u>Case In Point – Oil</u>

On December 12, as I began to write this memo, the *Financial Times* provided several examples of the negative thinking being applied. Here are some excerpts from an article about the recent market action:

> Oil prices fell sharply to a seven-year low, rattling stock markets at the end of a choppy week. . . . The price of Brent crude, the global energy benchmark, was down 5.6% to $37.49 . . . after Opec at its meeting a week ago failed to agree output cuts, leaving prices at the mercy of a global glut.
>
> "Lower oil prices are here to stay."
>
> The CBOE Oil Vix is holding above the 54 level . . . as investors pay up to protect themselves [against], or speculate upon, further sharp moves in crude.

That all sounds very serious. But is it? Does it make any sense? What's the real significance of declining oil prices?

The bottom line for me is that, if you aren't an oil company or a net oil-producing country, low oil prices aren't necessarily a bad thing. For net oil importers like the U.S., Europe, Japan and China, the drop we've seen in the price of oil is analogous to a multi-hundred-billion-dollar tax cut, adding to consumers' disposable income. It can also increase an importer nation's cost-competitiveness.

The U.S. is both a producer of oil and an importer. That means the macro economy will enjoy the benefit of cost reduction and income enhancement, but domestic oil companies and those who provide them with products and services will gain less from production than had been expected, and some state and local governments will be hard-hit. (And I must add that, thus far, the indicators fail to suggest a salutary impact on the broad economy.) Eighteen months ago I thought the ability to produce oil through fracking at a cost of $40-60 per barrel would give the U.S. a cost advantage in manufacturing; that's no longer likely, at least for now.

But the one thing that's beyond doubt is that the impact of the fall in the price of oil is far from all bad. In fact, I'd say that it's positive on balance for the U.S. and an unmitigated boon for the UK, Europe and East Asia. So why did the *FT* attribute market weakness to it? First, the media have taken on the unpleasant task of telling us why the markets went up or down each day, and the falling oil price is an easy answer . . . until you give it any real thought. Second, though, as the *FT* went on to explain, some worry might be appropriate regarding what it connotes:

> The fall in commodity prices is causing market anxiety because investors are worried that it signals a slowdown in global demand, and that any economic benefit from cheaper costs for consumers and businesses is being counteracted by the cutting of investments and jobs by the resources sector.

In other words, they're inferring that the price of oil declined because demand is off, and that this signals economic weakness. But economic growth is what it is; we don't need the oil price to tell us it's weak. And the price of oil is off another third in the last few months, even though world GDP is still growing.

The important thing isn't what the oil price decline tells us about today. It's what it says about tomorrow. And to me, everything else being equal, I think low energy prices today will contribute to better economic growth tomorrow. (Low prices today probably also imply higher prices eventually, through their impact on supply and demand.) It's just that everybody's interpreting everything negatively these days.

<u>Case In Point – Interest Rates</u>

The *FT* also pointed out that investors were reacting to the likelihood the Fed would raise interest rates, even though that should have been a foregone conclusion:

> Next week, the Federal Reserve will raise interest rates. That at least now appears likely. Anything else would be the biggest shock of a year in which markets and monetary authorities have had serious misgivings. Let us assume for now that it happens.
>
> This will be the longest-awaited and most-previewed tightening of monetary policy in history.

There's something wrong if an event that has been widely anticipated for years – and considered a near certainty for months – can be thought capable of significantly impacting the market when it becomes a fact. People's expectations should be incorporated into the prices they assign to assets. So a negative reaction to the imminence of a widely heralded interest-rate increase must imply that either (a) investors are too dense to have incorporated it into prices before this, (b) the increase will be a bigger deal than people thought, or (c) the market is irrational.

On December 15, Dow Jones published the following quote:

> "It's been more shoot first, ask questions later" in the shares of large asset managers, said Kenneth Hill, an analyst at Barclays PLC. "The concern is largely that as rates move higher, investors think returns will move lower and there will be some rotation out of fixed income. People are anxious to see how that plays out," he added.

When Mr. Hill said that, more than two and a half years had passed since May 2013, when Ben Bernanke foreshadowed a "tapering" of bond purchases and the possibility of higher interest rates. How can investors not have had enough time to adjust to the possibility of higher rates and incorporate it into asset prices? Indeed, the increase that was just days away should have been mostly a non-event, and the idea that it was a significant contributor to the declines on December 11 makes no apparent sense.

Over the years since Bernanke's statement in 2013, the question I've been asked more often than any other has been, "What month will the Fed begin to raise interest rates?" My response has been consistent: "I have no idea, and why do you care?" If someone tells me he'll do one thing if he thinks the Fed's going to raise rates in March and something different if it's going to happen in January, what he's demonstrated is that he doesn't understand how asset prices incorporate expectations. The difference in timing should have little effect on the choice of a course of action. What matters is how far rates will go, and how fast. I don't expect much of either from this dovish and cautious Fed . . . unless the economy surprises on the upside. **And that would be good news, wouldn't it?**

While on the subject of interest rates, I want to mention the thing about them that most annoys me these days. People who acted one way when rates were unchanged (even though everyone knew they wouldn't remain that way for long) are acting very differently now that there's been a quarter-point increase. This, they say, is because "we're in a rising-rate environment." But the issue of interest rates, like most others, shouldn't be viewed as binary . . . black or white . . . flat rates or rising. **The essential questions are, "how much will rates rise?" and "when the series of increases is over, will rates be high enough to meaningfully alter behavior?" That's what counts.**

Yesterday, *The Wall Street Journal* wrote as follows: "Analysts and investors attribute the [auto stocks' recent greater-than-market] declines to worries that rising U.S. interest rates could crimp auto finance and to fears that auto sales may have peaked." Does the interest rate outlook really mean significantly fewer cars will be sold . . . especially given that low gas prices are making consumers richer and driving cheaper? I think people may have jumped to an unwarranted – and negatively tinged – conclusion.

Case In Point – Third Avenue

In terms of investor reaction, I find the announcement that Third Avenue's Focused Credit Fund would liquidate to be the most interesting recent event. According to the *FT*:

> The liquidation of the biggest US mutual fund since 2008 has intensified concern for the health of the US corporate bond market.
>
> Some distinguished between a risk to the system, where issues at one fund trigger redemptions from others, and so-called idiosyncratic problems related to a single fund.
>
> Corporate bonds sold off again yesterday in the wake of the FCF liquidation announcement and many investors rushed to buy default insurance contracts on junk debt.

There isn't much to be in doubt about in the meltdown of the Focused Credit Fund; clearly it reflected problems peculiar to that fund alone. In 2014, while a $3½ billion fund, it had substantial holdings in particularly-high-risk, illiquid debt. Then it encountered snowballing capital withdrawals at a time of reduced market liquidity. Under circumstances like these, portfolio managers generally raise cash by liquidating their most salable holdings, causing the quality and liquidity of the remaining portfolio to decline. Continuing withdrawals took FCF's assets below $800 million in December 2015, and I hear it was down to 20 or fewer holdings, all of extremely low quality. Further redemptions would have forced the manager to sell those, realizing extremely low prices, eliminating any liquidity that may have been present, and leaving investors who hadn't redeemed holding the bag.

The fault certainly lies with the fund's managers. Risky, illiquid investments may be appropriate for closed-end funds whose capital is secure, but probably not for mutual funds or other vehicles subject to daily redemptions. It's debatable whether a fund should be expected to be able to handle both an 80%

loss of AUM and a substantial decline in liquidity. But, as I wrote in "Liquidity" (March 2015), "no investor should shoulder more illiquidity than its realities permit" and, in particular, "no investment vehicle should promise more liquidity than is afforded by its underlying assets." **Illiquid assets and the possibility of capital flight: there are few surer recipes for investment disaster.**

Investors lacking strong emotional and analytical foundations might have been scared into believing that FCF's problems connoted – or presaged – widespread weakness among high yield bonds and other forms of risky debt. Those who were a bit less panicky might have understood that high yield bonds in general were probably secure but still feared that illiquidity would combine with cascading redemptions to cause a chain reaction of capital withdrawals from other funds, forced sales, and collapsing bond prices. But those with adequate emotional and analytical resources would have recognized that FCF's problems were more endogenous and idiosyncratic than a function of high yield bonds broadly, and that adequate creditworthiness provides the debtholder's ultimate protection against chaos in the market.

Recent Developments

Behavioral economics and its younger cousin, behavioral investing, aren't theoretical. In fact, they're the essence of practical: they're about how human foibles cause real-life behavior to deviate from what theory might dictate.

In recent months we've had occasion to watch how mood swings can alter the investment environment. I'll describe below the events that have occurred in the market for distressed debt.

In the U.S., the years 2010-14 were characterized by gradual economic improvement, increasing corporate profits, a dramatic switch of the credit markets to accommodativeness, and – because of all this – some of the lowest default rates in history on low-grade debt. As a result, there was a paucity of distressed debt. Further, the little that was available was concentrated in just a few areas: European NPLs, real estate, shipping and power companies. Put these factors together, and Oaktree found itself unable to assemble large or thoroughly diversified distressed debt portfolios. Noting this, we followed up our record $10.9 billion fund raised in 2007-08 (and largely invested in the quarter following Lehman Brothers' bankruptcy filing) with one of $5.5 billion in 2010 and then another of $2.7 billion in 2011. In other words, we halved our investable capital and then halved it again.

There is no immediate connection (other than for companies doing business there) between the slowdown in China or the price decline in the oil patch, on one hand, and the general creditworthiness and desirability of high-risk debt on the other. And yet, over the last few months, pronounced changes have occurred in the market for distressed debt:

- After a period of very stable prices – even for "iffy" debt – some securities have "gapped down" in the last few months (i.e., fallen several points at a time rather than correcting gradually). In particular, investors have become highly intolerant of bad corporate news.
- For the first time since 2008-09, the debt of some companies outside of energy and mining has fallen from 90 to 60, and others from 50 to 20.
- **There is a general sense among my colleagues that investors have gone from evaluating securities based on the attractiveness of their yield (with company fundamentals viewed optimistically) to judging them on the basis of the likely recovery in a restructuring (with fundamentals viewed pessimistically).**
- The capital markets have begun the swing from generous toward tight, as is their habit. Thus, whereas they used to find it easy to refinance debt in order to extend maturities or secure "rescue

financing," now it's hard for companies – especially those experiencing any degree of difficulty – to obtain capital.

On December 7, Oaktree held a dinner in New York for equity analysts who follow our publicly traded units. Bob O'Leary, a co-portfolio manager of our distressed debt funds, planned to be among the hosts. But he called me on December 3 with a question I hadn't heard in a long time from my distressed debt colleagues: "Would you mind if I don't come? There's too much going on for me to leave the office." The change in investor attitudes had created investment opportunities where they hadn't existed just a few months before – in some cases out of proportion to the change in fundamentals.

Developments like these are indicative of rising pessimism, skepticism and fear. They're largely what Oaktree hopes for, since – everything else being equal – they make for vastly improved buying opportunities. But note that we may be just in the early stages of a downward spiral in corporate performance and credit market behavior. **Thus, while this may be "a time" to buy, I'm far from suggesting it's "the time."**

My Prescription

To help investors deal with their potential for "human error," this shrink would prescribe a number of elements that can help with the task:

- The first essential element in coping with markets' irrationality is **understanding**. The importance of psychology and its influence on markets must be recognized and dealt with.
- The second key lies in **controlling one's emotions**. An investor who is as subject as the crowd to emotional error is unlikely to do a superior job of surviving the markets' swings. Thus it is absolutely essential to keep optimism and fear in the appropriate balance.
- Emotional self-control isn't enough. It's also important to have **control over one's circumstances**. For professionals, that primarily means structuring one's environment so as to limit the impact on them of other people's emotional swings. Examples include inflows to and outflows from funds, fluctuations in market liquidity, and pressure for short-term performance. At Oaktree we never fail to appreciate the benefit we enjoy from being able to reject "hot money" and limit our funds' redemption provisions.
- And finally there's **contrarianism**, which can convert other investors' emotional swings from a menace into a tool. Going beyond just fending off emotional fluctuation, it's highly desirable to become more optimistic when others become more fearful, and vice versa.

I'm lucky to have received many gifts of investment insight early in my career. Perhaps foremost among them is one I picked up in New York about 40 years ago, at a lunch meeting of what we called the Third Thursday Group. It concerned the three stages of a bull market:

- the first, when only a few especially insightful people suspect improvement might occur,
- the second, when most people accept that improvement is actually taking place, and
- the third, when everyone concludes that things are sure to improve forever.

Between the first stage and the last, nothing has to have changed in terms of fundamentals. The difference lies in the perspective investors are bringing to their decisions. But clearly, it's great to be a buyer in the first stage and essential not to be in the last.

We know investors swing from rejecting all possibilities to drinking the Kool-Aid, just as the three stages say. Thus at Oaktree we want to buy when they're pessimistic, not when they're eager participants. **If I could know only one thing about an investment I'm contemplating, it might be how much optimism is embodied in the price.** In the first stage of the bull market, no optimism is present, and that makes for great bargains. In the last stage, the level of optimism is terribly high, and thus so are purchase prices relative to fundamentals. I want to buy when I can benefit from the herd's neuroses, not when they'll penalize me just as they do everyone else.

As I mentioned above, since the middle of 2011 – by which time the quest for return had resulted in rather full prices for debt, over-generous capital markets and pro-risk investor behavior – Oaktree's mantra has been "move forward, but with caution." We've felt it was right to invest in our markets, but also that our investments had to reflect a healthy dose of prudence. Except for the occasional air pocket, investors didn't suffer significant negative consequences prior to the last year or so. Thus, as usual, we were early in turning cautious. But opportunities (and returns) in the credit sphere have been only so-so since mid-2011, and I don't think our caution caused us to miss much.

Now, as discussed above, investors' optimism has deflated a bit, some negativity has come into the equation, and prices have moved lower. Depending importantly on which market we're talking about and how it has fared in recent months, we consider it appropriate to move forward with a little less caution.

* * *

While I have your attention, I want to devote a few paragraphs to the two questions I'm asked most often these days: What are the implications for the U.S. and the rest of the world of China's weakness, and are we moving toward a new crisis of the magnitude of what we saw in 2008?

At a time when the environment is marked by so many potential problems, it's important to figure out which if any are likely to present real problems. Declining oil prices: the implications for non-oil producers seem mixed at worst. A terrorist event: horrifying, but for any one person or location, I'd put it in the category of an "improbable disaster." The political picture: we'll probably continue to muddle through no matter who's elected.

I would say that, of all the things on the list, the possibility of a hard landing in China is of the greatest significance when you combine magnitude, potential ramifications and the probability of it occurring. So it's important to look objectively at what it means for the U.S.

First, let's remember that China doesn't play a pivotal role in the U.S. economy (other than as a provider of finished goods). It is estimated to account for only 1% of the combined profits of the S&P 500 companies. Exports account for about 13% of U.S. GDP, and in the first eleven months of 2015 less than 8% of our exported goods went to China ($106 billion of goods, versus an annual GDP approaching $18 trillion – again, well below 1%).

Going on from there, I want to share Paul Krugman's analysis from *The New York Times* of January 8. (I generally don't agree with Krugman's politics, but I don't think they're relevant here.):

> Yes, China is a big economy, accounting in particular for about a quarter of world manufacturing, so what happens there has implications for all of us. And China buys more than $2 trillion worth of goods and services from the rest of the world each year.

But it's a big world, with a total gross domestic product excluding China of more than $60 trillion. Even a drastic fall in Chinese imports would be only a modest hit to world spending.

What about financial linkages? One reason America's subprime crisis turned global in 2008 was that foreigners in general, and European banks in particular, turned out to be badly exposed to losses on U.S. securities. But China has capital controls – that is, it isn't very open to foreign investors – so there's very little direct spillover from plunging stocks or even domestic debt defaults.

All of this says that while China itself is in big trouble, the consequences for the rest of us should be manageable. But I have to admit that I'm not as relaxed about this as the above analysis says I should be. If you like, I lack the courage of my complacency. Why?

Part of the answer is that business cycles across nations often seem to be more synchronized than they "should" be. For example, Europe and the United States export to each other only a small fraction of what they produce, yet they often have recessions and recoveries at the same time. Financial linkages may be part of the story, but one also suspects that there is psychological contagion: Good or bad news in one major economy affects animal spirits in others.

So I worry that China may export its woes in ways back-of-the-envelope calculations miss . . .

I want to highlight Krugman's reference to "psychological contagion." It's interesting in this regard that, last week, the world's stock markets saw the following declines: S&P 500 – 6.0%, FTSE 100 – 5.3%, DAX – 8.3% and Nikkei – 7.0%. **I consider it highly unlikely that such uniform declines were the result of independent, objective analysis of the impact of events on each economy and company. Rather, I think they show the extent to which markets are linked by their investors' shared psychology.**

So what about the likelihood of another 2008-style crash? The bottom line for me is that a rerun of the Global Financial Crisis isn't in the cards:

- We haven't had a boom (either in the economy or in the stock market), so I don't think we're fated to have a bust. Because most businesses have been particularly loath to expand their facilities, I don't think they'll be slammed if revenues flatten or turn down.
- The leverage in the private sector has been reduced. This is particularly true of the banks, where leverage has gone from the region of 30+ times equity before the crisis to very low double digits today. And, of course, banks are now barred from investing adventurously for their own account.
- Finally, the main villain in the crisis was sub-prime mortgage backed securities. The raw material – the underlying mortgages – was unsound and often fraudulent. The structured mortgage vehicles were highly levered and absurdly highly rated. And the risky tranches ended up in banks' portfolios, causing them to require rescues. **Importantly, this time around I see no analog to sub-prime mortgages and MBS in terms of their combination of fragility and magnitude.**

I don't mean to suggest there aren't a lot of things to worry about: swollen central bank balance sheets; complete ignorance as to how they will be unwound and how interest rates will be moved higher; the seeming inability to generate economic growth and inflation; and the many other macro negatives listed earlier. A hard landing and substantial devaluation in China, the world's second largest economy, certainly could have far-reaching effects.

It's important that investors (as well as economists) avoid using words like "always," "never," "will," "won't," "has to" and "can't," and I try to do just that. But it's my view that the GFC and its preconditions were highly unusual, and I don't think we're heading for an encore. Remember, however, that I'm not a seer, and Oaktree and I never bet heavily on opinions regarding the future – mine or anyone else's.

*   *   *

Before I close, I want to make it abundantly clear that when I call for caution in 2006-07, or active buying in late 2008, or renewed caution in 2012, or a somewhat more aggressive stance here in early 2016, I do it with considerable uncertainty. My conclusions are the result of my reasoning, applied with the benefit of my experience (and collaboration with my Oaktree colleagues), but I never consider them 100% likely to be correct, or even 80%. **I think they're right, of course, but I always make my recommendations with trepidation**.

I read the same newspapers as everyone else. I see the same economic data. I'm buffeted by the same market movements. The same factors appeal to my emotions. Maybe I'm a little more confident in my reasoning, and certainly I have more experience than most. But the key is that – for whatever reason – I'm able to stand up to my emotions and follow my conclusions. **None of them can be documented or proved.** If they could be, most intelligent people would reach the same conclusions, with the same degree of confidence. I tell you this only to communicate my feeling that no one should fear he's not up to the task just because he's unsure of his conclusions. **These aren't things about which certainty is attainable.**

*   *   *

Lastly, they tell me Oaktree is now on social media. That means you can follow @oaktree on Twitter to receive updates about my memos, videos and speaking engagements, and to hear from others at the firm. You can also subscribe to my memos on our website, oaktreecapital.com/insights.

January 14, 2016

Memo to: Oaktree Clients

From: Howard Marks

Re: What Does the Market Know?

My buddy Sandy was an airline pilot. When asked to describe his job, he always answers, "hours of boredom punctuated by moments of terror." The same can be true for investment managers, for whom the last few weeks have been an example of the latter. We've seen bad news and prices cascading downward. Investors who thought stocks were priced right 20% ago and oil $70 ago now wonder if they aren't risky at their new reduced prices.

In Thursday's memo, "On the Couch," I mentioned the two questions I'd been getting most often: "What are the implications for the U.S. and the rest of the world of China's weakness, and are we moving toward a new crisis of the magnitude of what we saw in 2008?" Bloomberg invited me on the air Friday morning to discuss the memo, and the anchors mostly asked one version or another of a third question: "does the market's decline worry you?" That prompted this memo in response.

The answer lies in a question: "what does the market know?" Is the market smart, meaning you should take your lead from it? Or is it dumb, meaning you should ignore it? Here's what I wrote in "It's Not Easy" in September and included in "On the Couch":

> Especially during downdrafts, many investors impute intelligence to the market and look to it to tell them what's going on and what to do about it. This is one of the biggest mistakes you can make. **As Ben Graham pointed out, the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously.** Market participants have limited insight into what's really happening in terms of fundamentals, and any intelligence that could be behind their buys and sells is obscured by their emotional swings. It would be wrong to interpret the recent worldwide drop as meaning the market "knows" tough times lay ahead.

The rest of this memo will be about fleshing out this theme (meaning you can stop reading here if you've had enough or are short on time).

The Nature of Consensus Opinion

I based the above reference to Ben Graham on his famous observation that in the long run the market's a weighing machine, but in the short run it's a voting machine. In other words, in the long term the consensus of investors figures out what things are really worth and moves the price there. But in the short term, the market merely reflects consensus opinion regarding an asset's future popularity, something that's highly susceptible to the ups and downs of psychology.

So, what does the market know? **First it's important to understand for this purpose that there really isn't such a thing as "the market." There's just a bunch of people who participate in a market.** The market isn't more than the sum of the participants, and it doesn't "know" any more than their collective knowledge.

This is a very important point. If you believe the market has some special insight that exceeds the collective insight of its participants, then you and I have a fundamental disagreement. The thinking of the crowd isn't synergistic. In my view, the investment IQ of the market isn't any higher than the average IQ of the participants. And everyone who transacts gets a volume-weighted vote in setting an asset's price at a given point in time.

People of all different levels of ability act together to set the price. They vary all over the lot in terms of knowledge, experience, insight and emotionalism. The market doesn't give the ones who are superior in these regards any more influence than the others, especially in the short run. **My bottom line on this subject is that the market price merely reflects the average insight of the market participants.** That's point number one.

If anything, I think it's emotion that's synergistic. It builds into herd behavior or mass hysteria. When 10,000 people panic, the emotion seems to snowball. People influence each other, and their emotions compound, so that the overall level of panic in the market can be higher than the panic of any participant in isolation. That's something I'll return to later.

Now let's think about the first goal of investing: to buy low. We want to buy things whose price underestimates the value of the underlying assets or earnings (value investing) or the future potential (growth investing). **In either case, we're looking for instances when the market is wrong.** If we thought the market was always right – the efficient market hypothesis – we wouldn't spend our lives as active investors. Since we do, we'd better believe we know more than the consensus. **So by definition we must not think the market – that is, the sum of all other investors – knows everything, or knows more than we do, or is always right.** That's point number two.

And that leads logically to point number three: why take instruction from a group of people who know less than you do? In "On the Couch," I wrote that it all seems obvious: investors rarely maintain objective, rational, neutral and stable positions. Do you agree with that or not? Is the market a clinical and rational fundamental analyst, or a barometer of investor sentiment? Does the market's behavior these days look like something a mature adult should emulate?

It seems clear to me: the market does not have above average insight, but it often is above average in emotionality. Thus we shouldn't follow its dictates. In fact, contrarianism is built on the premise that we generally should do the opposite of what the crowd is doing, especially at the extremes, and I prefer it.

A Case in Point – The Crash of 2008

The year 2008 culminated in the greatest panic I've ever seen. The events that built up to it included:

- massive subprime mortgage defaults and the failure of mortgage backed vehicles,
- meltdowns at funds that had invested in those vehicles, notably two Bear Stearns funds,
- the collapse of Bear Stearns, necessitating its purchase by JPMorgan for almost no consideration,
- rescues of Merrill Lynch by Bank of America; Wachovia by Wells Fargo; and Washington Mutual by JPMorgan (after it was first seized by the Office of Thrift Supervision),
- decisions on the part of BofA and Barclays not to acquire Lehman Brothers, and on the part of the U.S. Treasury not to bail it out, leading to Lehman's bankruptcy filing,
- the appearance that Morgan Stanley would be next if it couldn't secure additional capital, and
- widespread speculation regarding other firms that might follow.

A massive downward spiral ensued. Among the contributing factors were:

- precipitous declines in the prices of bank stocks,
- large-scale short selling of the stocks (the "uptick rule" previously mandated that a stock could only be sold short at a price above the last trade, meaning short selling couldn't force the price down. But the rule was repealed in 2007, so there ceased to be limits on when stocks could be shorted. Thus short sellers could force stock prices down – whether intentionally, in what in the 1920s were called "bear raids," or just because they thought the stocks were right to sell),
- dramatic increases in the cost to insure the debt of banks through credit default swaps.

In the environment described above, the downward spiral in bank stocks was intensified by the following factors (whether they were intentionally manipulated, I can't say for sure):

- It was easy to bet against the banks by buying credit default swaps (CDS) on their debt.
- It was easy to depress bank stocks by selling them short.
- The declining stock prices were taken as a sign that the banks were weakening, causing the cost of buying CDS protection to rise.
- The rising cost of CDS protection was taken as an additional negative sign, causing the stocks to fall further.

I can tell you, it had the feel of an unstoppable vicious circle. Some compared it to the "China Syndrome": a 1979 movie with Jane Fonda and Michael Douglas in which an out-of-control nuclear reaction threatens to propel reactor components through the earth's core, from the U.S. to China. Thus the stock of panic-ridden Morgan Stanley (for example) fell 82%, to less than $10.

But it's important to note that the negative feedback loop described above was able to continue without reference to – and not necessarily in reasonable relationship to – actual developments at the banks or changes in their intrinsic value. Eventually, however, the Treasury restricted short selling in the stocks of 19 financial institutions deemed "systemically important." Morgan Stanley secured a $9 billion injection of convertible equity from Mitsubishi UFJ Financial Group. The panic subsided. The economy and capital markets recovered. And Morgan Stanley's stock traded at $33 a year later.

Do you wish you had taken the market's instruction in 2008 and sold bank stocks? Or do you wish you had rejected its advice and bought instead? In short, did the market know anything?

There are three possible answers:

- The market was flat wrong in 2008 when it took Morgan Stanley's stock so low.
- The market was right; it properly reflected the possibility of a meltdown that could have happened but didn't.
- The market was wrong in the case of Morgan Stanley in 2008, but most of the time it isn't.

I like the first, and the second is appealing as well. But while a meltdown certainly was possible, the below-$10 price probably assigned it too high a likelihood. And, of course, I'm not persuaded by the third.

A Case in Point – Senior Loans in the Financial Crisis

While on the subject of 2008, I want to review the performance of senior loans. In the old days, banks made corporate loans, sometimes sharing part with a syndicate of a few friendly banks but retaining the rest. More recently the custom changed, with banks syndicating their loans widely to buyers of all types and retaining rather little. This process has more in common with investment banks' underwriting of securities than with the commercial banks' prior lending process.

Senior loans became a significant area of activity for credit investors like us. They're typically their issuers' senior-most debt, so they're perceived to carry little credit risk. And since they pay interest at floating rates, there is no interest rate risk. (Of course, with so little risk, they offer low yields.) They're the highest-quality instruments I've ever dealt in.

Because they were considered so safe, loans were widely deemed appropriate for levered investment, and prior to the financial crisis large numbers of highly levered Collateralized Loan Obligations, or CLOs, were formed to hold them. Borrowing at low floating rates to buy senior debt paying high floating rates was very enticing, and the CLO business mushroomed.

Senior loans were affected dramatically by the events of 2008. Since senior loans had been used to fund buyouts with purchase prices at high multiples of cash flow, investors became concerned about the issuers' ability to service them, and especially to refinance them when they came due (since the capital markets had slammed shut). Loan prices fell to levels never seen before in the absence of a default; whereas non-distressed senior loans had rarely sold below 95 in the past, now they fell to the 80s, and then to the 60s. Because of the collapsing prices, "market-value" CLOs received margin calls they couldn't meet, and banks seized portfolios and liquidated them in overnight BWIC (bid-wanted-in-competition) transactions. The indiscriminate selling put further pressure on prices, leading to more margin calls and more BWICs: another prototypical negative feedback loop.

The senior loan index was down 29% in 2008. That exceeded the 25% decline of the high yield bond index. Why would senior debt fall more during a crisis than junior debt? The answer is that senior loans had been ground zero for buying with leverage (and thus for margin calls and forced selling) whereas high yield bonds had not.

The key questions were rarely asked while things melted down: what were the loans worth, and would they pay? That depended on the outlook for defaults, but in late 2008 few people felt they could assess it or could take the time required to do so. **And neither did they question the extent to which the price collapses had been caused by margin calls and forced selling, rather than investment fundamentals.** They just succumbed to negativity and sold.

When 2008 ended, and with it the cycle of selling, price declines, margin calls, more selling and more price declines, the prices of loans stopped going down. And then they went up. The senior loan index rose 45% in 2009, meaning someone who invested on December 31, 2007 and didn't sell was <u>up</u> 3% overall by December 31, 2009. What if you had taken the market's advice in the post-Lehman meltdown and sold in response to the negative signal? You'd have a valid complaint, but whom would you blame? The market . . . or yourself?

What Does a Falling Market Say About Value?

What do big price declines mean? They mean market participants sense fundamental deterioration. But what price declines say is reflective, not predictive. They tell you about the events that have occurred, and how investors have reacted to them. They don't tell you anything that the average investor doesn't know about future events. And, again, I'm firmly convinced (a) the average investor doesn't know much, and (b) following average opinion won't help you attain above average results.

Most of my readers want to perform better than the average investor. As I've set out in "Dare to Be Great II" (April 2014) and in the discussion of "second level thinking" in my book *The Most Important Thing*, to accomplish that, you have to invest differently than the average investor. To do that, you have to think differently than the average investor. And to do that, you have to consider different inputs than the average investor, or consider inputs differently. You simply can't follow the signals their behavior provides.

It's a matter of logic: if price movements reflect average opinion, following their supposed advice can't help you perform above average.

Now let's think about the question of whether to sell. Here are some possible reasons to do so:

- Belief that the price is high relative to the fundamentals.
- Belief that while the current price may not be high relative to the current fundamentals, the fundamentals will deteriorate in ways that aren't anticipated by the price. (In other words, the price is high relative to how the fundamentals will come to be viewed.)
- Belief that the price will fall regardless of the fundamentals, meaning that by selling today you can avert a loss and/or position yourself to profit by buying lower later.

Do you agree that these are the main reasons to sell? Are there others? Are these all legitimate?

For me the first two are compelling. This is what the skilled investor thinks about. Both of these decisions are made relative to something called "intrinsic value." **There's only one intelligent form of investing: figure out what something's worth and see if you can buy it at or below that price**. It's all about value.

But note that the third reason to sell shown above has nothing to do with value. The price may be high, low or fair relative to the fundamentals today or what they're expected to be tomorrow. You just sell because you think the price will fall.

First, does it make sense to sell something if the price is low relative to the fundamentals, just because you fear it may fall in the short run? A long-term value investor holds or buys when price is low relative to value. Low price relative to value is his dream. Why sell a low-priced asset just because you think it's going to fall for a while? Most people understand the challenge in dealing with "two-decision stocks": you sell because you think the price may fall (even though it may be something you'd like to hold for the long term), and then you have to figure out when to buy it back. Last year Charlie Munger complained to me that they're really "three-decision stocks": you sell it because you think the price is full, you have to figure out when to buy it back, and in the meantime you have to come up with something else to do with your money. **In my experience, most people who are lucky enough to sell something before it goes down get so busy patting themselves on the back that they forget to buy it back.**

All other things being equal, as something falls in price, you should want to own it more, not less. The buy-and-hold value investor is stalwart, ignoring price fluctuations. Even better, the contrarian moves opposite to the market, buying when the price falls and selling when it rises.

Second, if not on the basis of fundamentals, how does one make the decision to sell for the third reason listed above? Essentially, two things give rise to changes in asset prices: changes in the outlook (macro or asset-specific) and changes in attitudes toward the asset. In other words, fundamentals and valuation. Fundamentals are dealt with above. If you're going to try to benefit from changes in price that are unrelated to changes in fundamentals, you're left having to predict investor psychology. If "On the Couch" wasn't successful in convincing you this isn't possible, this memo probably won't be, either.

My bottom line is that markets don't assess intrinsic value from day to day, and certainly they don't do a good job during crises. Thus market price movements don't say much about fundamentals. **Even in the best of times, when investors are driven by fundamentals rather than psychology, markets show what the participants <u>think</u> value is, rather than what value really is.** Value is something the market doesn't know any more about than the average investor. **And advice from the average investor obviously can't help you be an above average investor.**

<u>What Does a Falling Market Say About Psychology?</u>

Fundamentals – the outlook for an economy, company or asset – don't change much from day to day. **As a result, daily price changes are mostly about (a) changes in market psychology and thus (b) changes in who wants to own something or un-own something.** These two statements become increasingly valid the more daily prices fluctuate. Big fluctuations show that psychology is changing radically.

And, I said on page two, emotional fluctuations – swings in market sentiment or psychology – do seem to be synergistic. That is, in crowd psychology, 2 + 2 = 5. **While I don't think the price of an asset reflects more wisdom than is possessed by the average of its market's members, I do believe mass psychology will make a group swing to reach greater emotional extremes than its members would separately.** In short, people make each other crazy. And when times are bad – like now – they depress each other. That was a factor in the edge enjoyed by our distressed debt team in 2008: they were able to buy at the market's lows because they weren't in New York, where everyone was trading scary stories and getting each other down.

Again, we can gain insight through logic. **We all know we want to buy (not sell) at the lows, and sell (not buy) at the highs. So then how can it be right to sell because of a decline or buy because of a rise?** Advocates of this latter approach must think (a) declines and rises tend to continue more than they reverse and/or (b) they can tell which declines mean "buy" and which mean "sell." Some savants may have that latter ability, but not many. In general, I think it's ridiculous to sell something because it's down (just as it is to buy because it's up).

As prices fall, there are some very genuine reasons to sell:

- Some people feel rising fear and have to lighten their positions in order to retain their composure.
- Some, having lost a lot of money, sell to be sure they won't experience losses they can't survive.
- Some have to sell to repay demanding creditors or satisfy investor withdrawals.

These reasons are not "invalid." It's just that none of them has anything to do with making money.

Most mature investors know intellectually that short-term price fluctuations are low in fundamental significance, and that the best results will be achieved if they hold on to their positions and ride out the volatility. But sometimes people sell anyway, perhaps for the above reasons. **Doing so has the potential to convert a short-term fluctuation into a permanent loss by causing any subsequent recovery to be missed. I consider this the cardinal sin in investing.**

What Do the Media Know?

I'm usually able to find something in the print or broadcast media that helps me make my point. Here's how *The New York Times* led the business section on Saturday:

> **Concern Grows That Market Sell-off is an Early Warning of a U.S. Slowdown**
>
> It may be time for everyone to take the markets seriously again.
>
> As stock prices started tumbling in the first trading days of the year, many Wall Street professionals were tempted to describe the declines as the sort of adjustment that the market has gone through in recent years before moving higher.
>
> But that opinion evaporated this week as the selling intensified. Concerns are now growing that the markets are signaling that the United States economy, despite its recent bright spots, is on the verge of a slowdown.
>
> The fear is that economic problems in China have set off negative reactions around the world that could ultimately weigh on American households and corporations.

So the bottom-line question is simple: does the market reflect what people know, or should people base their actions on what the market knows? And if the latter, where does "the market" get its information, other than from people? For me it's simple: if people follow the market's dictates, they're taking advice from . . . themselves!

I set a trap at the beginning of this memo, and I want to spring it now. In the first paragraph, I wrote, "We've seen bad news and prices cascading downward." You probably glossed over it. But is it true? Leaving aside China and the markets' gyrations, have we really been seeing negative news on balance? Isn't it just that people are fixating on bad news, ignoring good news, and tending to interpret things negatively?

There are ways in which psychology can become "real," feeding back to influence fundamentals. One is that declining asset prices produce a negative "wealth effect," making people feel poorer and causing them to spend and invest less. And there are others. But despite the feedback influences of the market declines, I still would say U.S. and European economic fundamentals aren't negative on balance.

On Friday, in the midst of the declines, I participated in a small lunch attended by investment professionals and current and former senior government economic and financial leaders. I'll spare you the details: **there was a lot of "on one hand" and "on the other hand," but no one thought there would be a recession this year**. So then who are the people creating price signals to which others should accord significance?

*   *   *

I want to end by making one thing completely clear. I'm not saying the market is never right when prices go down (or up). I'm merely saying the market has no special insight and conveys no consistently helpful message. **It's not that it's always wrong; it's that there's no reason to presume it's right.**

It is the goal of some investors to sell on declines when the subsequent movements will be down, but "buy the dips" when the subsequent movements will be up. If you think you can tell which is which from watching the market movements themselves, then we – again – have a fundamental disagreement. Future price movements can only be predicted on the basis of the relationship between price and fundamentals. And, given the market's short-term volatility and irrationality, this can only be done in the long-term sense**. The market has nothing useful to contribute on this subject.**

January 19, 2016

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Memo to: Oaktree Clients

From: Howard Marks

Re: Economic Reality

Addendum, June 13: There's been a lot of response since the memo that follows was originally published on May 26. In the discussions that have ensued, I realized that I should have led with something like this:

> ***Ultimately, economics is the study of choice.*** *Because choices range over every imaginable aspect of human experience, so does economics. . . .*
>
> *How do individuals make choices: Would you like better grades? More time to relax? More time watching movies? Getting better grades probably requires more time studying, and perhaps less relaxation and entertainment. Not only must we make choices as individuals, we must make choices as a society. Do we want a cleaner environment? Faster economic growth? Both may be desirable, but efforts to clean up the environment may conflict with faster economic growth. Society must make choices. . . .*
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> *We would always like more and better housing, more and better education – more and better of practically everything.*
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> ***If our resources were . . . unlimited, we could say yes to each of our wants – and there would be no economics. Because our resources are limited, we cannot say yes to everything. To say yes to one thing requires that we say no to another. Whether we like it or not, we must make choices.***
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> ***Our unlimited wants are continually colliding with the limits of our resources, forcing us to pick some activities and to reject others.*** *Scarcity is the condition of having to choose among alternatives. (Macroeconomics Principles, Libby Rittenberg and Tim Tregarthen. Emphasis added)*

Because of the above, we make economic choices every day. Everyone knows choices like these are inescapable.

Everyone, that is, except for politicians. The politician promises better grades and more leisure time. A cleaner environment and faster economic growth. That's what caused me to write the memo: ***in politics and government – unlike the real world – the word "or" often goes out the window, replaced by "and." No choices are necessary.***

*A few months ago I saw a cartoon featuring caricatures of two primary opponents. Under one it said "bulls**t" and under the other it said "free s**t." There's bound to be a lot of the former in any election season, but economics tells us the latter is unrealistic. I wrote this memo to help readers understand why.*

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In 1977, responding to the difficult energy outlook brought on by the Arab Oil Embargo, President Jimmy Carter created the position of Secretary of Energy and chose James Schlesinger as America's first "energy czar." Previously Schlesinger had served as Chairman of the Atomic Energy Commission, Director of Central Intelligence, and Secretary of Defense, and in his early days he taught economics at the University of Virginia. I was tickled by a story – undoubtedly apocryphal – about his days in academia that made the rounds when Schlesinger was in his new energy post.

As the story went, Schlesinger was such a convincing evangelist for capitalism that two students in his economics class decided to go into business after graduation. Their plan was to borrow money from a bank, buy a truck, and use it to pick up firewood purchased in the Virginia countryside, which they would then sell to the grandees in Georgetown. Schlesinger wholeheartedly endorsed their entrepreneurial leanings, and they proceeded with great enthusiasm. From the start of their venture, the former students could barely keep up with the demand.

Thus it came as quite a shock when their banker called to tell them the balance in their account had reached zero and the truck was about to be repossessed. They contacted Schlesinger, and he listened attentively as they recounted their experience: they had, in fact, been able to acquire vast amounts of wood for $50 a cord, and they'd been able to sell all they had for $40 a cord. How could they be broke? Where had they gone wrong? Schlesinger puffed on his ever-present pipe and said: "The answer's obvious: you need a bigger truck."

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While it certainly wasn't the case with Schlesinger (despite what the above tale suggests), most ordinary citizens don't have what it takes to figure out what is and isn't economically feasible. Since we're in the midst of election season, with promises of cures for our economic woes being thrown around, this seems like a particularly appropriate time to explore what can and can't be achieved within the laws of economics. Those laws might not work 100% of the time the way physical laws do, but they generally tend to define the range of outcomes. It's my goal here to point out how some of the things that central banks and governments try to do – and election candidates promise to do – fly in the face of those laws.

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When I was in high school, one of my buddies convinced me to take a class in accounting. I found the double-entry bookkeeping we learned to be logical, symmetrical and unambiguous. After accounting I moved on to economics, and I found it equally logical. The die was cast for my career in business.

Like the lesson of the Schlesinger story, the rest of economics is also pretty straightforward, and its laws are quite reliable. If you buy for $50 and sell for $40, you won't make money . . . period (or stay in business long). That reminds me of a joke I used in "bubble.com" in January 2000, one my father told me roughly 60 years ago:

> "I lose money on everything I sell."
> "Then how do you stay in business?"
> "I make it up on volume."

For those of us in the business world, economics defines reality. (You may think you've heard me poke at it, but what I deride is economic forecasting, not economics. There's a big difference.) The realities of economics are the subject of this memo. My primary methodology will be to describe ways in which people (and especially politicians) tend to propose things that conflict with economic reality, and explain why they're unlikely to work.

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Let's start with central banks' attempts to achieve monetary stimulus. When central banks want to help economies grow, they take actions such as reducing the interest rates they charge on loans to banks or, more recently, buying assets ("quantitative easing"). In theory, both of these will add to the funds in circulation and encourage economic activity. The lower rates are, and the more money there is in circulation, the more likely people and businesses will be to borrow, spend and invest. These things will make the economy more vibrant.

But there's a catch. Central bankers can't create economic progress; they can only stimulate activity temporarily. GDP, or national output, can be seen roughly as the amount of labor employed times productivity, or the amount of output per unit of labor. In the long term, these things are independent of the amount of money in circulation or the rate of interest. The level of economic activity is determined by the nation's productiveness.

Central bank actions can encourage or accelerate economic activity, but they can't create economic activity that otherwise wouldn't occur. Much of what central banks do consists of making things happen today that otherwise would happen sometime in the future. It's not clear that the effects are long-lasting or anything more than an acceleration of events within the confines of a zero-sum game. What is beneficial, however, as Professor Randall Kroszner of the Chicago Booth School of Business wrote me, is the fact that:

> [Central banks] can help to prevent a complete financial meltdown and the negative economy-wide externalities associated with a financial collapse. In these circumstances, and if done appropriately, their actions can do more than just move up future production to the present by helping to avoid economic activity losses due to a panic.

In the old days, when cars often failed to start, there were fluids we could squirt into the carburetor to get them going. But they weren't fuel for long-term operation.

For example, lending people money can enable them to buy things today that they otherwise mightn't have bought until later (if at all). If a consumer buys a boat today with money made available through a low-interest loan, that's a boat he won't buy next year. Lending people money doesn't alter their lifetime incomes, meaning consumers may buy fewer boats later, when the loans have to be repaid, causing disposable income to contract.

So far, as the last seven years show, (a) central banks haven't been able to generate the growth they hoped for and (b) the impact of each successive jolt of stimulus seems to have been less powerful.

Rather than believing central banks can make economies more productive, it's my bottom line that there's a naturally occurring growth rate for each economy, and that rate dictates the long-term output, not central bankers' actions.

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What have the following places had in common in recent years: China, Ireland, Spain and Arizona? The answer's simple: large numbers of empty new homes. In the last decade-plus, governments and central banks chose to encourage economic growth in these jurisdictions by making financing readily available for construction. This can do wonders for an economy . . . as it did in these cases in the years leading up to the crisis of 2007-08.

Construction increases the demand for labor, building materials, support services and ancillary businesses. There's only one catch: easy financing – especially if sufficient to cover 100% of costs – can encourage developers to create space for which there's no demand. The process of creating unsalable homes, unneeded office space and uneconomic infrastructure adds to GDP in the short run but burdens the countries' financial systems, especially the institutions that make the loans to builders. In the end, the bad loans stay with the banks, perhaps necessitating bailouts.

Another example can be seen in the case of Sainty Marine, a Chinese state-owned enterprise that recently made headlines by becoming China's first listed company to file for bankruptcy. Sainty Marine first bought and sold ships and then transitioned into shipbuilding, acting on contracts that – unlike elsewhere in the industry – were entered into without the benefit of financial guarantees. It needed financing in order to build those ships, and got it from state-owned banks. **But when a state-owned bank lends money to a state-owned shipbuilder, who's making business-like decisions? Who worries about issues like whether there'll be charters for the ships and whether owning them will be profitable?**

The point is that mistakes like overbuilding are always possible – but they're much more likely to occur if no one's making decisions on an economic basis. If lending personnel are making loans without a direct stake in their repayment, they're less likely to say "no" to weak loan applicants. And if borrowers won't be affected by a failure to repay loans, which of them will decline offers of financing?

Not all loans work. And when they don't work, both the lender and the borrower are usually affected. As someone once said, "bankruptcy is to capitalism as hell is to Catholicism." **When the parties involved aren't motivated by profit or worried about loss, good economic decisions are unlikely to be made.**

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Riding to work the other day, I heard about protests occurring in France. Workers were complaining about potential changes in labor regulations that would make their jobs less secure. In brief, French workers like it the way things are: they can't be pushed beyond 35 hours a week, and employers' ability to terminate them is subject to a drawn-out, torturous and uncertain program. They also like their lengthy vacations and the extensive benefits provided by the state. **The question is where the ability to pay for above average benefits will come from if neither the hours worked nor the productivity per hour is above average.** Governments and regulations can't produce prosperity.

In the current campaign, Bernie Sanders has called for free health care and free public college education for all. And all the candidates have sworn to protect the current level of Social Security benefits, which are sure to render the system insolvent absent other changes. Benefits like these have to be paid for. This can be done either out of "current earnings" – a share of GDP (i.e., tax revenues) – or through borrowings. But governments can't create out of thin air the means with which to make disbursements. In that way they're not so different from households or businesses.

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One way some governments think they can pull off the miracle of providing more is by raising taxes on the rich. After all, the rich have – by definition – more money than they need: everyone else gets by on much less.

"Populism" has been a strongly rising element in politics over the last decade. It primarily means drawing class distinctions and claiming to be on the side of the common man. This often comes down to playing on the resentment of the lower-earning majority toward the wealthy minority. Populism is a particularly strong force in the U.S. presidential election now underway, fed by economic dissatisfaction among the working class due to the effects of globalization, job outsourcing, and technological progress with which some haven't kept up. "Outsider" or non-establishment candidates in both parties – Donald Trump and Bernie Sanders – are having a lot of success telling voters the economy isn't working for them and appealing to resentment toward those who are doing better. Now even Hillary Clinton is saying of the wealthy and powerful, "The deck is stacked in their favor . . . my job is to reshuffle the cards."

Taxes are the main instrument for politicians to put class resentment to work. Many eventually resort to an old saw: "We're not out to soak the rich. We just want them to pay their fair share." I discussed this subject at length in "It's All Very Taxing" (November 2011). In my view, however, (a) there's no way to determine what the fair share is, (b) there are only the opinions of self-styled experts on this subject, and (c) "fair share" always seems to come down to "more than they've been paying."

It makes sense to assume that most democratic societies eventually will reach the point where the majority views the top tier as a cash cow available for unlimited milking. "Let's hit them for a little more; there's nothing they can do about it." But the truth is, this "tyranny of the majority" is an unhealthy development. First, society does better when able members have strong incentive to contribute. Second, upward aspiration and mobility will be constrained when taxes become confiscatory. Finally, taxpayers aren't necessarily powerless in the face of rising tax rates.

That brings me to an article that appeared in *The New York Times* on April 30, entitled "One Top Taxpayer Moved, and New Jersey Shuddered." It concerns the impact of rising rates on taxpayer behavior, starting from the fact that New Jersey's biggest single earner had moved to Florida. (New Jersey has raised its top income tax bracket from 6.37% in 1996 to 8.97% today, whereas Florida doesn't have a state income tax.)

> "If you're making hundreds of millions of dollars and you're paying close to 10 percent to the state of New Jersey, you do the math," said John Bramnick, the Republican leader in the New Jersey Assembly. "You can save millions a year by moving to Florida. How can you blame him?" . . .
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> In New York, California, Connecticut, Maryland and New Jersey, the top 1 percent pay a third or more of total income taxes. Now a handful of billionaires or even a single individual . . . can have a noticeable impact on state revenues and budgets. . . .
>
> In California, 5,745 taxpayers earning $5 million or more [or only 4/100s of a percent of the 13.6 million returns filed] generated more than $10 billion of income taxes in 2013,

> or about 19% of the state's total, according to state officials. "Any state that depends on income taxes is going to get sick when one of these guys gets a cold . . ."

While not everyone would change their residence to reduce their taxes, some will. Remember that seven of the 50 states do not tax their residents' incomes. **Thus the bottom line on this – I think the good news in terms of fiscal responsibility – is that states have no choice but to think of taxpayers as mobile. If you raise the top tax rate by 10%, you won't collect 10% more taxes from them.** A surprisingly large number of the people Nancy and I meet in New York have their residences in Florida. That's a reflection of economic reality – and should restrain the tendency to excessively tax the rich.

The U.S. is one of only a tiny number of countries whose citizens are taxed on all their worldwide income, regardless of where they live or where their income is earned. Thus, Americans don't have a good way to escape federal income taxation by moving abroad. (Technically, they can leave the U.S. tax system by paying the taxes that would be due if they were to sell all their assets and realize all the appreciation to date. But they also have to surrender their citizenship and sacrifice frequent visits to the U.S., and the number of people willing to do all this is limited.)

Citizens of almost every other country have an easier way to respond when the "soak-the-rich" movement arrives (see the big earners who moved away when France enacted a 75% top rate a few years ago). **Thus most governments are aware that while they can raise tax rates on people of means, in most cases they can't make them sit still and take it.**

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Another way national governments can make it easier to accomplish their financial goals is by printing money. But flooding the market with more currency debases the value of the currency. They can increase people's nominal incomes, but eventually they'll find their fatter wallets don't contain any more spending power than they used to.

In "The Limits to Negativism" (October 2008), I discussed the fact that in Weimar Germany, the government took the 1,000 mark note and over-stamped it "One Million Marks." But it still only bought one goat.

> The mark fell from 60 to the U.S. dollar in early 1921 to 320 to the dollar in early 1922 and 8,000 to the dollar by the end of 1922. It's hard to believe, but according to Wikipedia (user-maintained and perhaps not always the most authoritative):
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> > In December 1923 the exchange rate was 4,200,000,000,000 Marks to 1 U.S. dollar. In 1923, the rate of inflation hit 3.25 x 10^6 percent per month (prices double every two days).
> >
> > One of the firms printing these [new 100 trillion Mark] notes submitted an invoice for 32,776,899,763,734,490,417.05 (3.28 x 10^{19}, or 33 quintillion) Marks. [That's not a misprint.]

The great advantage for governments in creating inflation lies in the ability to meet obligations with debased currency. That was the motivation behind Germany's hyperinflation in the 1920s – to make it easier to cover expenses and debts denominated in Marks.

Today most nations want to see inflation. That would reduce the "real" value of their national debt and ease repayment in real terms. Treasuries and central banks have tried to encourage inflation by cutting interest rates and increasing the amount of money in circulation. Quantitative easing, for example, consists of the Fed using newly printed dollars to buy outstanding debt; this should increase the amount of money in circulation and thus raise the dollar price of goods. Voilà: inflation.

But governments' efforts have been strikingly unsuccessful and, so far, inflation is MIA. Inflation is a mysterious (and, I think, largely psychological) phenomenon. **The U.S. government couldn't figure out how to stop it in the 1970s, and the nations of the world can't find a way to start it today.** Classically, inflation has resulted from (a) "demand pull" – too many buyers for a fixed supply of goods, or (b) "cost push" – rapid increases in the costs of production. Neither of these causes is in evidence today. Thus inflation is quite feeble, and that's disappointing to countries that would like to pay their debts with cheaper currency.

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A related tool for national economic betterment consists of another route toward currency debasement: devaluation. A nation can increase its ability to deal with the rest of the world by adjusting its currency's rates of exchange.

Let's say the U.S. wants to increase its exports of manufactured goods. One way to do this is to make the goods cheaper. But what if the dollar costs of manufacturing can't be reduced? In that case, why not just reduce the amount of foreign currency it takes to buy a dollar's worth of goods?

For example, let's say the selling price of a U.S. widget is $100, and there are 10 Ruritanian kopeks to the dollar. Thus a widget costs 1,000 kopeks in Ruritania. Say we change the exchange rate to 8 kopeks to the dollar. Now that widget costs a Ruritanian buyer only 800 kopeks. The number of dollars the U.S. seller receives is unchanged, but the number of kopeks the Ruritanian buyer has to pay for a widget is reduced by 20%. Sales of U.S. widgets to Ruritanians skyrocket.

Of course, while a weaker currency makes a country's exports more competitive, it also means its citizens have to pay more of their home currency to buy imports. **So, as in the case of the other things under discussion here, there's no free pass. There's little a country can do in terms of policy actions to improve its situation that (a) doesn't have negative ramifications and (b) will enhance the long-run outlook in the absence of fundamental improvement in economic efficiency.**

And, by the way, here's another wrinkle: you can't just devalue your currency; you can only devalue it **against another currency**. What happens when multiple countries want to devalue at the same time? China tries to devalue the yuan versus the yen, but Japan tries to devalue the yen relative to the yuan. This is called "competitive devaluation." **The one thing we can be sure of is that every country can't simultaneously devalue versus all the others . . . try as they may.**

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This discussion of devaluation and exchange rates leads eventually to the entire issue of globalization and international competition. Globalization is one of the most important and influential topics today, and it is shaping economic progress and political discourse.

Let's go back to the early post-World War II period. The U.S. mainland was physically and economically intact – having been spared from combat – while Europe and Japan had been decimated. U.S. corporations were performing strongly, and the prosperous U.S. consumer was the source of powerful demand. In most fields, American products were the best in the world. "Imported cars" were essentially non-existent, and the television sets, hi-fis and appliances our parents (or grandparents) bought were produced here. Even our clothing was made in America.

In this very positive economic environment, consumers, producers and workers all thrived, and in most regards, Americans enjoyed the highest standard of living in the world. Now that is in doubt, and this has become a main issue in the presidential campaign. Here's how I put things in "What Worries Me" (August 2008):

> One of the reasons for our high standard of living is the fact that Americans have been paid more for doing a given job than everyone else. This was fine as long as (a) the U.S. enjoyed the benefits listed [earlier], and (b) significant barriers protected the status quo. But why should this go on? How can it go on?
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> Think about two cities. City A has more jobs than people, and city B has more people than jobs. Initially, people in city A – where labor is relatively scarce – will be paid more for doing a given job than people in city B. **The key to their continuing to earn more is the existence of barriers that prevent people from moving to city A.** Otherwise, people will move from city B to city A until the ratio of people to jobs is the same in both cities and so are the wages. **Among other things, geographic inequalities are dependent on the immobility of resources.**
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> For much of the last century, barriers kept our pay high. Other countries' output wasn't as good as ours. Some lacked investment capital, and some were decimated by war from time to time. Perhaps they didn't possess our ability to generate technological advancements or our managerial skills. High transportation costs, tariffs, prejudices (when I was a kid, "Japanese transistor radio" was synonymous with "low quality") or legal restrictions (e.g., keeping foreign airlines from competing freely in our markets) may have protected American wages. International trade wasn't what it is today. But all of these things can change over time, and it's hard to see how the earnings supremacy of U.S. workers will be sustainable. . . .

In 1949 we saw the arrival of a little car called the Volkswagen Beetle. It was odd, with its rounded shape and the engine in the back, but boy was it cheap: roughly $1,300. The quality of foreign cars was initially the subject of skepticism, but over time quality improved, the superior price/value bargain overcame cultural resistance, and the share of car sales going to imports grew.

Two Volkswagens were sold in the U.S. that year, then hundreds, and then many thousand. Soon Japan started to send over the Toyota, Datsun (now Nissan) and Honda, and they were successful, too. To put their success into perspective versus those two Beetles in 1949, in 1981 the Japanese automakers entered into a "voluntary restraint agreement" limiting the number of cars they could bring into the U.S. to 1.68 million per year. More recently Korea began sending cars to the U.S. Today foreign brands account for more than 55% of car sales in the U.S. market. Of course a good part of the success of imports has been related to lower costs. (A substantial number of the "foreign brand" cars sold in the U.S. today are actually made here, but in non-unionized plants at total labor costs including benefits that average \$10/hour, or \$250/car, less than the U.S. carmakers' unionized plants. In the past, when foreign cars were actually made abroad, the cost differential was much more dramatic.)

U.S. automakers' market share was destined to decline if foreign cars were some combination of better and cheaper. And when it did, U.S. autoworkers' income and standard of living had to start to equalize relative to those building better-value-for-the-money cars abroad. Trade barriers, high transportation costs, a strong union and inertia kept the U.S. worker ahead as the 20th century wore on, but eventually reality caught up with the industry.

Here's an example: the autoworkers' union had bargained for excellent benefits for auto workers, and according to the Economic Policy Institute:

> In 2005, there was a gap of \$3.62 between the average hourly wage of \$27.41 at Ford and \$23.79 for [foreign-owned plants]. When fringe benefits, legally required payments, pension benefits, retiree health care, and other post-employment labor costs are added in, the gap grew to \$20.55 (\$64.88 versus \$44.33).

There was a limit on the ability of U.S. automakers to sell cars burdened with substantial benefit costs while foreign car costs included much less for benefits. **The bottom line is that, in a globalized world, if people in country A will work for less than those in country B, there are only four possibilities for manufacturers in country B:**

- **charge a higher price for the same product and lose market share,**
- **charge the same price for the higher-cost product and enjoy smaller profit margins (or even suffer losses),**
- **charge the same price for an inferior product (this probably can't be done for long), or**
- **get the government to erect trade barriers on imported goods, such as a tariff that equalizes selling prices or a quota that restrains competition.**

Thus the operating and financial condition of U.S. automakers deteriorated such that, during the Global Financial Crisis, General Motors and Chrysler declared bankruptcy (enabling them to cut costs and shed benefits), and Ford underwent a thorough restructuring with the same result. Workers' more modest contracts since then have, of necessity, caused their relative standard of living to decline. This is an example of the reasons behind the working class's current discontent.

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Of course, this leads me to the idea that probably did more than any other to set the wheels in motion for this memo: "we'll bring back the jobs." One of Donald Trump's most emphatic promises is that he will respond to America's loss of manufacturing jobs to other nations by causing goods to be made here again. Bernie Sanders opposes free trade and argues we must "develop trade policies which demand that American corporations create jobs here, and not abroad." Are these actionable positions?

(A minute for an aside: U.S. manufacturing employment of 12.3 million workers is down 37% from the peak of 19.5 million reached in 1979. So when did the value of manufacturing output hit its peak? The answer may surprise you: **today!** The current level of U.S. manufacturing output is in the vicinity of the all-time high and roughly double the 1979 level. Twice the output with less than 2/3 the workers means output per worker has more than tripled. Thus, if we were producing today's output at the 1979 level of productivity, we'd be employing 25 million more workers! So while we've lost 3.2 million jobs to China since 2001, for example, we've lost many times that to improvements in productivity. **Perhaps if the government wants to preserve jobs it should just outlaw productivity gains.** That thought reminds me of the early-19th-century Luddites, English textile workers who were unhappy about industrialization and banded together to destroy labor-saving factory machinery. Of course, history shows it's hard to hold back economic progress by edict or force of will.)

Let's assume it's possible to manufacture high-labor-content goods like cellphones much more cheaply in China than in the U.S. (not an unreasonable assumption, since the average manufacturing worker in China makes less than $9,000 per year). And let's assume the resulting cost to deliver a cellphone to an American retailer is $100 if made in China versus $150 if made in the U.S. In that case, a Trump or Sanders administration would have the following choices:

- forbid imports of cellphones, requiring that they be made in the U.S. at a cost of $150,
- find Americans willing to work at Chinese wages, bringing the cost down to $100, or
- impose a trade tariff on Chinese imports that equalizes the U.S. retailer's cost for phones at $150.

I'm not aware of any other possibilities. The first probably isn't feasible in this day and age. The second is equally unlikely, since few Americans are likely to elect to do the tedious work involved, and the Chinese wage of less than $5 per hour would violate our federal minimum. That leaves the third option: tariffs. And, in fact, Mr. Trump has said he would impose a 45% tariff on Chinese imports, 35% on Mexico, and various tariffs on goods from other countries. Here are some of the problems with that:

- First, such tariffs are probably barred under trade agreements that are in place. To impose them, we would have to abrogate those agreements.
- We have to wonder about retaliatory actions – wouldn't other countries impose offsetting tariffs on U.S. exports that would further harm our manufacturing base? As *The New York Times* wrote on May 3, "starting a trade war might be cathartic for workers who have lost jobs, but it is unlikely to create a lot of factory work."
- What would happen to our ability to refinance our perpetually growing national debt if China, our biggest creditor, decided one day it wasn't quite as eager to participate in new Treasury financings?
- What would rising barriers do to one of the main motivations behind the broadening of U.S. trade agreements since World War II: preventing conflict?
- **Finally, but most simply, what American wants to pay 50% more for a cellphone than he does today?**

What we have here is a reminder that "economic common sense" isn't so common. Have the voters who think it's a great idea to "bring back the jobs" thought about what goods manufactured at U.S. wages – or tariffs designed to bring the cost of Chinese goods up to those levels – would do to their cost of living? I'd guess not. **How will the interests of the 3.2 million Americans estimated to have lost their manufacturing jobs to China be balanced against the hundreds of millions who would have to pay considerably more for imported goods? Not an easy question.**

Quotas, tariffs and subsidies are all ways for countries to protect industries that can't hold their own against international competitors without these things. Thus they're a good example of ways in which policy decisions can lead to distortions. **Since the industries for which tariffs and subsidies are**

established are, by definition, industries that can't compete without them, for these things to be enacted, someone has to make a decision that (a) these industries should be kept afloat and (b) consumers of these industries' goods should be prevented from paying the lower prices that would prevail if consumers had easy access to goods from abroad, free of tariffs.

Do we want to subsidize our farmers, or do we want to allow Americans to buy cheap crops from abroad (and let the farmers go out of business)? Leaving aside strategic national considerations, do we want to protect the jobs of those who work in industries where the U.S. is uncompetitive, or do we want to allow U.S. consumers as a whole to minimize their cost of living? **In each case, it's one or the other . . . but not both.**

The bottom line, as with so many of the things I'm discussing here, is that economic laws cannot be ignored or magical solutions willed to appear. While it's far from the entire explanation, the main reason the U.S. has lost manufacturing jobs to foreign countries is that people there are willing to work for much less. **In this globalized world, that means Americans can't enjoy both the high-paying manufacturing jobs they used to have <u>and</u> the low-cost goods they've been buying of late. The imposition of tariffs can't solve that conundrum.** As long as American workers demand wages higher than people elsewhere, they're unlikely to manufacture much for the rest of the world, or for themselves, either. This is an incredibly clear example of how economic reality makes it hard to find easy solutions to difficult problems.

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While on the subject of wages, it's appropriate to mention the minimum wage. The U.S. government first established a federal minimum wage of $0.25 an hour in the Fair Labor Standards Act of 1938. It has been raised 22 times since then and now stands at $7.25. At the state level, there's a patchwork of regulation. A few states don't have a minimum wage. Some have minimums that are below the federal level. Many states use the federal minimum, and a bunch have minimums higher than the federal level.

Just this year, however, increases in the state minimum to $15 (with exceptions) have been enacted in California (by the end of 2021, from $10 today) and in New York (by the end of 2018-19, from $9 today). As the wages of the lowest-paid workers increase, where does their newfound prosperity come from, and what will be the effects?

The debate over increasing the minimum wage is loud and inconclusive . . . and mainly a matter of ideology. Conservatives and business interests are sure an increase in the minimum wage will be disastrous for both business and workers. If higher wages drive up selling prices vis-à-vis competitors who face lower labor costs, business and jobs will suffer. If selling prices and non-labor costs are unchanged, there's a fixed pie to be divided up (between workers' wages and business owners' profits). Thus, if you mandate higher pay per worker and the owners' slice remains the same, the wage slice of the pie by definition will cover fewer recipients; the result is job losses. And if instead you take the higher wages out of the owners' part of the pie, fewer businesses will start up, and some might close, again resulting in job losses.

Liberals and labor organizations, on the other hand, insist there will be no material impact. For example, according to a study from the National Employment Law Project, following most of the 22 federal increases since 1938, job formation didn't slow from what it had been. And in the few cases where it did slow, the increase took place in recessionary times, so maybe it wasn't the result of the wage increase.

In between these polar positions (neither of which is probably completely right), there are lots of things to think about:

- What's right for undifferentiated businesses (think fast food) in a high-minimum-wage state abutting one where the wage is much lower?
- Is the same minimum wage right for all businesses in a given state regardless of their varying degrees of labor-intensiveness?
- Is the same minimum wage right for all businesses in a state regardless of their profitability? And what about non-profits like hospitals, with their heavy reliance on low-cost labor?
- Is the same minimum wage right for all parts of a state regardless of the differences in their economic vibrancy and cost of living?
- And is a benign job-formation-impact history relevant given that we're now talking about increases of 50-100%, large changes relative to history, and given that the U.S. no longer has all the growth potential and competitiveness that it did when the prior increases took place?

Senator Sanders has said he'll enact a $15 minimum federal wage. Is it possible that $15 is an appropriate minimum for all regions, states and cities? (It's interesting to note in this regard that the proposed changes in New York and California treat New York City differently from Rochester, and Los Angeles differently from Bakersfield.) And if a single minimum wage isn't right for every location, what government commissariat will perform the impossible task of setting the right minimum for each one?

I don't mean to decide the minimum-wage issue here, but rather to say it's not an easy subject. **It seems unlikely that you can make everyone better off just by mandating a higher wage.** Some businesses will become less successful or non-viable. Business formation may be discouraged. The breakeven cost for further investment in automation will decline. (Headline from today's *Washington Post*: "Ex-McDonald's CEO says raising the minimum wage will help robots take jobs") Some workers may lose their jobs or fail to get jobs. Remember, governments and regulators don't create wealth, they only redistribute it. Their impact is largely a zero-sum game except in the longest-term sense.

* * *

As an avowed "democratic socialist," Bernie Sanders expresses hostility toward business, especially the financial sector – "The business model of Wall Street is fraud" – and he sounds like he'd go pretty far to regulate the economy. For instance, he's said he will break up the big banks (without much mention of how).

Rather than go into all the economic laws his policies violate, I'll simply ask some questions I consider relevant:

- What has been behind the United States' progress to the top of the world's economic heap? (If he doesn't attribute a lot of our success to the capitalist, free-market system, then we disagree.)
- Where are the countries that have thrived under control economies? How about the U.S.S.R. and East Germany? (Didn't the ability to watch the former East Germany and West Germany side-by-side provide a good controlled experiment?) How do average folks live in Cuba, Venezuela and Vietnam? Why is China continually increasing its use of free-market techniques?

How about an example of central economic control in action? Here are some excerpts from an article about Venezuela that appeared in *The Atlantic* of May 12, 2016 (I've added some emphasis and reordered the paragraphs):

> A case in point is the price controls, which have expanded to apply to more and more goods: food and vital medicines, yes, but also car batteries, essential medical services, deodorant, diapers, and, of course, toilet paper**. The ostensible goal was to check inflation and keep goods affordable for the poor, but anyone with a basic grasp of economics could have foreseen the consequences:** When prices are set below production costs, sellers can't afford to keep the shelves stocked. Official prices are low, but it's a mirage: The products have disappeared.

Here's a shocker: you can set prices for goods, but you can't make people produce them. That sounds a lot like economic reality.

These ineffective – or counterproductive – price controls were only one part of a huge economic mess. How did it arise?

Not long ago, Venezuela – "a seemingly modern, seemingly democratic nation just a few hours' flight from the United States" – was wealthy and a good place to live.

> Sitting atop the world's largest reserves of oil at the tail end of a frenzied oil boom, the government led first by [Hugo] Chavez and, since 2013, by [Nicolas] Maduro, received over a trillion dollars in oil revenues over the last 17 years.

But then it saw the beginning of:

> The experiment with '21st-century socialism' as introduced by . . . Chavez, a self-described champion of the poor who vowed to distribute the country's wealth among the masses, and instead steered the nation toward the catastrophe the world is witnessing under his handpicked successor Maduro . . .
>
> In the last two years Venezuela has experienced the kind of implosion that hardly ever occurs in a middle-income country like it outside of war. Mortality rates are skyrocketing; one public service after another is collapsing; triple-digit inflation has left more than 70 percent of the population in poverty; an unmanageable crime wave keeps people locked indoors at night; shoppers have to stand in line for hours to buy food; babies die in large numbers for lack of simple, inexpensive medicines and equipment in hospitals, as do the elderly and those suffering from chronic illnesses.

This is the fate that has befallen a once-wealthy and once-modern nation operating under central economic control. Shall we give it a try?

*　　*　　*

For me, the bottom line on economic reality is that, in the short run, governments theoretically have the ability to:

a) **accelerate economic activity**, bringing forward to today otherwise-future activity,
b) **make life better for one group of citizens at the expense of another** (e.g., the rich versus the poor), and
c) **encourage one form of activity versus others** (e.g., investing for capital gains versus investing for dividends).

One could view these things as potentially helpful policy tools, or as actions that distort the workings of the economy. By definition, they are designed to accomplish results that wouldn't occur if the market were left free. Perhaps not all the goals are truly desirable, and some may cease being considered desirable after they've been enshrined in law, possibly because of unintended consequences. Some issues – for example, the question of whether income on capital should be taxed higher or lower than income from labor – are just a matter of opinion based largely on political point of view. Some actions taken may be nothing more than patronage and rewards for voter loyalty.

In contrast to the above list of things governments can do to affect economies, there's a significant list of things they can't do.

a) **They can't create much net growth, wealth or prosperity through stimulus alone.** A certain quantum of wealth is produced by an economy. It can be moved around, but governments can't increase it magically.
b) **They can't make everyone better off simultaneously.** For the most part they can only take from one group to give to another. An example is the ability to improve the fortunes of workers in an endangered industry through import tariffs that raise prices for the industry's customers.
c) **There aren't many actions they can take that won't have repercussions for people other than the ones they're intending to benefit, and second-order consequences for everyone.** France can enact regulations that protect current jobholders by making it difficult to lay them off, but those same regulations will deter entrepreneurs and owners from starting or expanding businesses and hiring new employees.
d) While governments can provide incentives and nudge people in a given direction, **they can't make economies (or the people in them) perform as desired**. For example, in the 1990s the Japanese government tried to stimulate consumption by mailing out checks (something that's referred to today as "helicopter money"). But its conservative citizens put the money in the bank rather than spend it, turning the government's action into a classic case of "pushing on a string."

Fundamental improvements – intelligent changes in investment incentives, the tax system or infrastructure, for example – can increase the slope of the growth curve and provide substantial net long-term benefits for a society (although not necessarily for every individual member). Short-term fixes simply cannot create wealth out of thin air. I'll close with something Winston Churchill said, with some additions of my own: "We contend that for a nation to try to tax [or stimulate or devalue] itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle."

May 26, 2016

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Memo to: Oaktree Clients

From: Howard Marks

Re: Political Reality

My last memo, in May, was on the subject of "Economic Reality." Its goal was to describe the realities imposed by economics and point out the many ways in which governments and, especially, candidates for elected office ignore and promise to override them. Since then I have been struck by the way developments have moved economic reality to center stage. Of course, foremost among them has been the affirmative vote of June 23 on Brexit: whether the United Kingdom should leave the European Union.

I have no interest in writing a memo about Brexit itself. There's a huge number of moving parts, too little past experience, too many varying opinions, and zero clarity on how the departure will be handled. There are many pundits out there telling us what the consequences of Brexit will be. The only thing I'm sure of is that most of them are wrong, and if I were to join their ranks, I'd probably be wrong, too.

<u>Economic Reality: Choices and Consequences</u>

The May memo described the ways in which economics defines and constrains reality in business, investing and everyday life. Economics establishes the rules of the game and the boundaries of the playing field, and these things can't be ignored. They can be altered, but not without consequences.

The realities of economics are stark and consistent, but also logical. They aren't absolute, like the laws of physics (e.g., gravity), but they reliably establish tendencies and limits. If the price of something goes up, the amount consumed is likely to go down. If wages rise, the number of people employed for a task is likely to decline. If tax rates go up, there's likely to come a point at which there's less incentive to work, and thus less output. If a government spends more, to pay the bills it has to either print money (which tends to be inflationary), raise taxes or borrow.

Shortly after publishing "Economic Reality," I added a new section to the version appearing on Oaktree's website, saying **economics is largely the study of choice**. If you only have $10, do you want to buy a $10 book or two $5 hamburgers, or make a $10 gift, or add $10 to your savings? The only thing we know you can't do is do them all. **Further, decisions and actions have consequences**. For example, spending can provide us with enjoyment, but it will also make us poorer.

<u>Reality in Politics</u>

I've always gotten a kick out of oxymorons – phrases that are internally contradictory – such as "jumbo shrimp" and "common sense." I'll add "political reality" to the list. The world of politics has its own, altered reality, in which economic reality often seems not to impinge. No choices need be made: candidates can promise it all. And there are no consequences. If something might have negative consequences in the real world, politicians seem to feel free to ignore them. If someone annoying, like a journalist or an opposing candidate, asks about potential consequences, it's easy these days to misrepresent them or deny they exist. And if it turns out that costs or consequences were willfully ignored, no redress is available: election victories based on unmet promises can't be rescinded, and candidates can't be sued over falsehoods on the stump.

In the addendum to "Economic Reality," I pointed out that candidates rarely talk about choice. Instead, they're likely to promise "all of the above." And rarely if ever do they mention the cost that will be attached to something, or the downside, as in "I'll give you A, but you'll have to give up B." I imagine page one of *The Politician's Handbook* must say "never deliver an unpleasant message."

In "What Worries Me" (August 2008), I wrote:

> Imagine two candidates for president. One says, "I'm going to give you eight years of discipline and denial – of higher taxes and lower spending – but I'll leave the country in better shape." The other says, "I have a secret plan that will solve all of our problems without requiring any sacrifice on your part." Who do you think would win?

How about a real-world example? In 1984, Walter Mondale was the Democratic candidate for president, running against Republican incumbent Ronald Reagan. Mondale became famous for his candor in accepting his party's nomination:

> Whoever is inaugurated in January, the American people will have to pay Mr. Reagan's bills. The budget will be squeezed. Taxes will go up. And anyone who says they won't is not telling the truth to the American people. . . . **Mr. Reagan will raise taxes, and so will I. He won't tell you. I just did.**

The result? Mondale lost in a landslide, with the popular vote of 59% to 41% representing the seventh-biggest percentage deficit in presidential election history. Far worse, of the 538 electoral votes, he won only 13 (the District of Columbia and his home state of Minnesota). That stands as the second-lowest electoral total for a presidential runner-up since 1824. **So much for the benefits of candor.**

Today many politicians promise to safeguard the Social Security system, but rarely do we hear anyone talk about (a) reduced benefits, (b) higher Social Security tax rates, (c) a higher ceiling on wages taxed, (d) delayed onset of benefits, or (e) means-testing for recipients. **And yet, either some combination of these or the insolvency of the system is an actuarial certainty.** Instead, we get the candidate's mantra: more for all, with no cost or consequences . . . and, in the case of Social Security, a complete absence of progress.

Brexit: Political Reality in Action

Being in Europe at the time of the Brexit vote gave me an opportunity to see the imperfections of political reality in action. I'll review a few:

- **The decision to conduct the referendum was a matter of political expediency** (defined as "the quality of being convenient and practical despite possibly being improper or immoral"). A schism in the Conservative Party between the pro-Europe faction and the Euro-sceptics (pronounced "skeptics") – as well as opposition from the UK Independence Party, or UKIP – threatened to hand Britain's 2015 election to the Labour Party. To put down this threat, Conservative Party leader David Cameron promised in 2013 to put the issue of membership in the European Union to a popular vote. We often see politicians paper over a problem with promises today, preferring to put off the possible consequences until tomorrow (they seem to assume tomorrow will never come – see page 4). This is a very practical stratagem, since elected officials often leave office well before consequences appear, and at any rate, there's no consolation prize for losing an election, so a candidate might as well do everything he can to win.

- **Potential consequences are often overlooked or not understood.** Of course, the ramifications of a Brexit referendum couldn't be known in 2013; even now in 2016 no one knows what they'll be, although the decision to leave is a fait accompli. It was a glaring error to leave a decision of this importance and permanence up to a simple majority of those going to the polls. The referendum could have been structured so that a decision to leave required a supermajority of those voting, or a majority of registered voters (whether they voted or not). **Since neither of these was required, the decision was made to take the UK out of the EU** – possibly tearing the country asunder (e.g., Scotland may well secede from the UK, since it was tempted to do so before and strongly wishes to be part of the EU) – **because 37% of registered voters said that's what they wanted** (whereas 35% voted to Remain and the other 28% didn't vote).

- **The decision was likely influenced by factual inaccuracies and false promises.** For example, probably most importantly, "Leave" voters were told that exiting the EU would enable Britain to gain control over its borders and thus exclude immigrants. Further, voters were told the UK was sending £350 million weekly to the EU, and leaving would enable that to be spent on the National Health Service instead. Within days after the election, however, some of those who had made the promises admitted that (a) maintaining unfettered access to the European market – and its 500 million consumers – will probably make it impossible to close Britain's borders to immigrants from Europe; (b) the £350 million was a gross figure that ignored the money the EU sent back to subsidize British farmers, and the real net figure was closer to £200 million per week; and (c) no one really thought the whole savings could go to the NHS – maybe just "a good part."

- **It became clear soon afterward that winning the election and implementing the decision are two different things.** Britain soon saw that (a) no one had a plan for how the departure would take place and (b) implementing wouldn't be as much fun as campaigning. Thus:

  - David Cameron (who had urged a vote to "Remain") announced the next day that, since he wasn't the right person to engineer a departure, he would resign as Prime Minister and head of the Conservative Party.
  - Ex-London Mayor Boris Johnson, a leading Conservative agitator for Leave, who it was widely assumed would become the next Prime Minister, walked away after his unsuitability was made clear in something of a coup.
  - Jeremy Corbyn, the head of the Labour Party, whose tepid effort failed to reflect his party members' strong support for Europe, was the subject of a 172-40 no-confidence vote by the Labour members of the House of Commons.
  - The leader of UKIP, Nigel Farage, stepped down, saying he wanted his life back after many years of advocating for Britain's departure from Europe.

  Thus, two weeks after the referendum, no one knew who would lead any of these parties. (Since then Theresa May has ascended, surprisingly quickly, as Prime Minister and head of the majority Conservatives.)

The English have a great expression: "a dog's breakfast." The meaning is simple: a complete mess. I think that's an apt way to describe the Brexit referendum.

To pull this part of the memo together, I can't overstate my appreciation for the way Thomas Friedman described the UK's situation in *The New York Times* on June 29:

> A major European power, a long-time defender of liberal democracy, pluralism and free markets, falls under the sway of a few cynical politicians who see a chance to exploit public fears of immigration to advance their careers. They create a stark, binary choice on an incredibly complex issue, of which few people understand the full scope – stay or quit the E.U.
>
> **These politicians assume that the dog will never catch the car** and they will have the best of both worlds – opposing something unpopular but not having to deal with the implications of the public actually voting to get rid of it. But they so dumb down the debate with lies, fear-mongering and misdirection, and with only a simple majority required to win, that the leave-the-E.U. crowd carries the day by a small margin. The dog catches the car. And, of course, it has no idea what to do with this car. There is no plan. There is just barking.

<u>The Voting Booth</u>

Now let's think about the nature of elections. In *The Intelligent Investor*, Ben Graham described the stock market as a weighing machine in the long run but a voting machine in the short run. What he meant by the latter reference was that in the short run, intrinsic value is often ignored and the stocks that do best are usually the ones capable of winning a popularity contest.

I believe that, over time, elections have become more like popularity contests. The successful campaign speech isn't one that does the best job of analyzing the challenges and supplying optimal solutions. It's one that most provides what people want to hear.

In business and investing, people invariably compare the benefits and costs of A against the benefits and costs of B. Then they select the alternative with the better expected net result (and hopefully one whose bad outcomes are survivable). A lot of mistakes may be made, and the process is sometimes misguided, but the effort to make good economic decisions is undeniably there. Decisions usually have clear consequences, and they are likely to become known before the people responsible depart.

In contrast, politicians tend to believe the best decision is the one that is most likely to lead to election or reelection. Responsibility for outcomes is highly diffused, and the results may only become clear years – or decades – after the elections are held and the decisions are made. Few voters have the ability to assess the reasonableness of candidates' promises, and – given the time lags mentioned just above – it can be difficult to judge candidates for reelection on the basis of their performance on the job.

Time for an aside: I don't claim that people in the private sector "do God's work." But we generally pull together to work for the collective good when the incentives are aligned properly. While everyone at Oaktree wants to advance his or her own financial position, status and career potential, I'm certain they also want Oaktree and its clients to succeed, as that is a prerequisite for – and will be a prime contributor to – each individual's own success. In Washington, on the other hand, many elected officials (Republicans and Democrats alike) give the impression that the success of the government – and the country – takes a backseat to making sure that (a) they and their fellow party members are elected and reelected and (b) members of the other party aren't. To this end, some members of party A seem to consider it more important to ensure that party B is unable to claim any accomplishments, than it is that party A actually gets something done. I saw a political advisor interviewed on TV, and when asked what makes a politician successful, he answered, “getting reelected by his or her constituents.” He quickly amended that to “getting legislation done,” but the message was clear.

The Quality of Debate

It’s only hesitantly that I use the above section heading to describe what I want to cover here. First, it seems there’s little of quality in political speech today, and second, I don’t see a lot of debate (in the sense of “a method of formally presenting an argument in a disciplined manner” – Wikipedia).

- Rather than organized point and counterpoint, voters today – certainly in the U.S. – are subjected to sound bites, insults and assertions that aren’t in response to anything. During a presidential debate in 2012 (which in retrospect seems so prim and well-mannered compared to today), one candidate – when told by the moderator that he hadn’t answered the question – said “you asked the question you wanted to ask; I answered the question I wanted to answer.”

- Unlike earlier years, there do not seem to be any rules governing what some people will say, or subjects that are off-limits.

- Some candidates seem to believe the truth is dispensable. In past elections, candidates could be heavily damaged if it could be shown that they’d said something inaccurate or untrue. This time around, the truth doesn’t seem to be accorded a universally high priority. According to PolitiFact, an independent fact-checking outlet, 28% of Hillary Clinton statements that they’ve checked are “Mostly False” or worse. In Donald Trump’s case, it’s an astounding 70%.

- In fact, it seems to me that, among certain portions of the electorate, there’s little concern for what’s said – just how it’s said. Over and over I hear people on TV say, “I like Trump because he tells it like it is.” They’re not necessarily commenting on his policies or the accuracy of his statements; more likely it’s his outspokenness and disdain for political correctness. In recent decades, it seems “this is someone I’d like to have a beer with” has taken the place of “this is the person who’s best qualified to lead the country.”

I’ve thought for the last year that the Republican primary “debates” had the feeling, more than anything else, of the professional wrestling matches I watched on television when I was a boy. Each wrestler had a persona that appealed to a certain segment of the crowd, and the fans of the villains would scream their support, faces contorted in rage. Dirty tricks and cheating didn’t push away these fans – in fact, these things just stirred their bloodlust. That certainly seems to be the case with some of today’s campaign moments. The parallels between politics and pro wrestling might even extend to attempts to rig the outcome. Just last month, the head of the Democratic National Committee was forced to resign because of staffers’ leaked emails proposing that it favor one candidate over another.

Ignoring Economic Reality

I listed above some of the false promises that led to the victory for “Leave” in the Brexit referendum. I also mentioned that there was a lot of backtracking on those promises in the weeks following the vote. Now I want to discuss a few questionable statements that have been made in the lead-up to the U.S. presidential election.

- **Some of Donald Trump's most prominent economic pronouncements have been with regard to imports, job losses and the balance of trade.**

  - He says of China, "they're killing us." But trade is a two-way street. Barring unfair competition, when we run trade deficits – meaning we buy more from other countries than they buy from us – it's for one main reason: they provide a better price/value proposition than we do. They sell products (and take jobs), but we get bargains. China isn't "winning" in that case, and the U.S. isn't "losing": it's a win for both countries. **Of course it's also true that while the result may be positive for the countries overall, there still can be negative consequences for individuals. For example, people may lose their jobs because of cheap imports, and society should take steps to ease their loss.** I'll return to this later.

  - Trump cites unfair competition from China as a main source of our loss of manufacturing jobs. As I pointed out in "Economic Reality," however, in recent decades the U.S. has lost roughly ten times as many potential jobs to increased productivity, mechanization and automation as it has actual jobs to low-cost competition from China.

  - Trump blames part of China's ability to sell cheap goods on the fact that it has held its currency artificially low versus the dollar. But it's interesting to note that when China recently made its exchange rate less rigid, the yuan declined rather than rose, suggesting that perhaps it hadn't been held artificially low.

  - As for economic reality, never has Trump said anything like this: "We may be able to increase manufacturing jobs by imposing protective tariffs, but that would require all consumers to pay higher prices for their purchases of goods from abroad." What would the average American's everyday shopping experience be if imported goods were barred, discouraged or heavily taxed?

- **Further, Trump doesn't point out that, in response to the adoption of protectionist measures by the U.S., other countries could retaliate with increased tariffs on U.S.-made goods, costing some Americans their jobs.** Here's what Moody's Analytics says about his original economic agenda (I haven't yet seen analysis of the plan he announced on August 8):

  > Broadly, Mr. Trump's economic proposals would result in a more isolated U.S. economy. Cross-border trade and immigration will be significantly diminished, and with less trade and immigration, foreign direct investment will also be reduced. While globalization has created winners and losers in the U.S. economy in recent decades, it contributes substantially to the ongoing growth of the U.S. economy. Pulling back from globalization, as Mr. Trump is proposing, will thus diminish the nation's growth prospects.

  Trump's campaign is mainly targeting people who fear being left behind by globalization, and ignoring the individual winners and positive overall effects (much as "Leave" campaigners did in the UK).

- **Trump claims his expertise and experience in business would enable him to put the U.S. economy on a better track.** Here's Moody's take on the original plan:

> Mr. Trump's economic proposals will also result in larger federal government deficits and a heavier debt load. His personal and corporate tax cuts are massive and his proposals to expand spending on veterans and the military are significant. Given his stated opposition to changing entitlement programs such as Social Security and Medicare, this mix of much lower tax revenues and few cuts in spending can only be financed by substantially more government borrowing.

According to Moody's, Trump's program would cause the federal budget deficit to increase from $640 billion today to $3,151 billion in 2026 (rather than $1,289 billion under current law), and federal government debt to increase from $14 trillion today to over $37 trillion in 2026 (versus about $24 trillion under current law – all figures in 2009 dollars, adjusted for inflation).

- **Finally, I'll mention Trump's most unrealistic claim: that he could trim the federal debt by negotiating the ability to pay it off at a reduced amount.** He built his net worth in part by borrowing money and not paying it back, and he seems proud of his companies' repeated use of bankruptcy as a strategic tool. But Trump doesn't have an ongoing need to tap the world capital markets, as the U.S. does (he now operates under an asset-lite business model that emphasizes licensing fees rather than asset ownership; perhaps this is because his multiple defaults have caused the credit window to be closed to him). **The United States could refuse to pay its debts in full – that's called "rescheduling" or "default" – but we'd be unlikely to have the same access to the credit markets, and we would certainly cease to enjoy the benefits of a high credit rating and resulting low interest rates.**

As for my picking on Trump here: I'm quick to point out that Clinton has her own shortcomings as a candidate and potential president. Her use of a private email server while Secretary of State is just one prime example. And she has embraced positions, such as opposition to the Trans-Pacific Partnership and her promise of free public college at certain income levels, that seem intended simply to help her compete against Bernie Sanders in the primaries and win over his supporters in the general election. But I think it's fair to say that she hasn't been anywhere near as guilty as Trump of defying economic reality on the campaign trail, and that's my subject here.

The Sources of Today's Division

One prominent characteristic of the political arena today is the rise in discontent, much of it based on economics. The world is changing in ways that are uncomfortable for many, especially those lacking the ability to change with it. Here's some of what I wrote in "What Worries Me" (August 2008):

> In many ways, including materially, Americans have enjoyed a wonderful standard of living over the last hundred years. Considering creature comforts such as housing, food, sanitation, healthcare, leisure and luxuries, ours may have been the highest standard of living in the world. That raises three questions:
>
> - Why should we continue to enjoy the highest standard of living?
> - Why should it continue to improve?
> - And why should the rate of improvement outpace that of the rest of the world?

> We often see poll results showing that increasing numbers of Americans doubt their children will live better than they do. We'd like them to, but why should they? Other than technological improvements which doubtless will continue to make life better for everyone, why should our standard of living improve monotonically? And improve relative to the rest of the world? Certainly the advantage in this regard can shift to other countries, just as it shifted to us in the past.
>
> One of the reasons for our high standard of living is the fact that Americans have been paid more for doing a given job than everyone else. This was fine as long as (a) the U.S. enjoyed significant post-war competitive advantages and (b) significant barriers protected the status quo. But why should this go on? How can it go on?
>
> Think about two cities. City A has more jobs than people, and city B has more people than jobs. Initially, people in city A – where labor is relatively scarce – will be paid more for doing a given job than people in city B. The key to their continuing to earn more is the existence of barriers that prevent people from moving to city A. Otherwise, people will move from city B to city A until the ratio of people to jobs is the same in both cities and so are the wages. Among other things, geographic inequalities are dependent on the immobility of resources.
>
> For much of the last century, barriers kept our pay high. Other countries' output wasn't as good as ours. Some lacked investment capital, and some were decimated by war from time to time. Perhaps they didn't possess our ability to generate technological advancements or our managerial skills. High transportation costs, tariffs, prejudices (when I was a kid, "Japanese transistor radio" was considered synonymous with "low quality") or legal restrictions (e.g., keeping foreign airlines from competing freely in our markets) may have protected American wages. International trade wasn't what it is today. **But all of these things can change over time, and it's hard to see how the earnings supremacy of U.S. workers will be sustainable.** (Emphasis added)

Unfortunately, these 2008 observations, and especially the final sentence, proved to be on target. And the central issue – globalization of trade, or the opening of national borders for the free movement of goods – has raised serious issues and become a source of controversy in the current election.

The good news about free trade is that an overwhelming majority of economists believe it contributes to economic progress. For example:

> A study by the Peterson Institute found that past trade liberalization laws added between $7,100 to $12,900 in additional income to the average household. A study by Peter Petri and Michael Plummer estimates that the Trans-Pacific Partnership, which Trump opposes and Clinton sort of opposes, would boost American incomes by $131 billion. (David Brooks, *The New York Times*, July 1)

What's the source of these gains? They come primarily from specialization. When borders are closed, each country has to produce all the goods it needs. But when borders are open, each country will produce the goods it can make best or cheapest. Each will sell some of its output to other nations that can't make those things as well or as cheaply, and each will buy from other nations that which it can't produce as well.

> There are good reasons for international specialization, and by and large Americans have benefited tremendously. Do we really want to produce T-shirts here and pay $60 for something that now costs $15? (Professor Gregory Mankiw, chairman of the Council of Economic Advisers under President George W. Bush, in *The New York Times*, July 15)

Clearly this process makes the overall global production system more efficient – everything is made where it can be done best – to the enrichment of all nations . . . but not all people. The benefits to date have been far from evenly distributed. In the U.S. they have gone overwhelmingly to those who are better educated and technologically adept or who own the companies that profit. Real incomes for people in the lower portion of the distribution have been stagnant at best, and the percentage of Americans participating in the work force – either employed or looking for a job – has declined.

As I described in 2008, Americans historically have been paid more than their counterparts around the globe. **This creates incentives to both manufacture abroad and automate at home.** (It also creates a condition that attracts immigrants – some illegal – who are willing to work for less.) Manufacturing employment is down a third since 1979, despite economic growth and increased manufacturing output. **Americans who lack education and thus are suited only for manual work** – who may have found jobs in agriculture a hundred years ago or in auto and appliance plants fifty years ago – **now face declining income trends . . . to some degree in absolute terms, and significantly when compared to (a) Americans with the education required for higher incomes and (b) the way things used to be, especially for their parents.**

> **In the past, in addition to the fact that incomes weren't so enormous at the top, the income gap was narrowed by the fact that people could do pretty well at the bottom. Millions of menial and blue-collar jobs were created as our economy expanded.** Even without much education, people could enjoy the good things in life, including cars, TVs and vacations, along with good public school educations for their kids and the possibility that most of those kids would have better jobs than their parents. Which of those elements is equally true today? ("What Worries Me")

I remember first becoming aware of income inequality – and certainly of unequal quality of life – during my first business trip in 1970, which was to Los Angeles. As a kid who grew up in Queens, New York, I had never seen anything like the verdant neighborhoods and beach communities of Southern California. Now the divergent trends in income are tearing at our society and influencing political events. A deteriorating income outlook and increasing income disparity have led to frustration, resentment, economic nationalism, protectionism and xenophobia among those affected.

As *The New York Times* put it on July 13:

> In the years that followed [the mid-1990s], the number of immigrants living in the United States illegally would double and then triple before leveling off under the Obama administration around 11 million. Deindustrialization, driven in part by global trade, would devastate the economic fortunes of white men accustomed to making a decent living without a college degree.

The economic reality is that these trends – international specialization, automation, rising productivity, job losses, the need for education, and a feeling of hopelessness among those affected negatively – are real and powerfully influential. Whether we like them or not, they're here to stay. They're economic reality, and they cannot be ignored or refuted.

I'll move toward summing up on the causes of today's conditions by quoting from Thomas Friedman in *The International New York Times* of June 30. I think he did a great job of capturing the situation:

> It's the story of our time: **The pace of change in technology, globalization and climate have started to outrun the ability of our political systems to build the social, educational, community, workplace and political innovations needed for some citizens to keep up.**
>
> We have globalized trade and manufacturing, and we have introduced robots and artificial intelligent systems, far faster than we have designed the social safety nets, trade surge protectors and educational advancement options that would allow people caught in this transition to have the time, space and tools to thrive. It's left a lot of people dizzy and dislocated.

Friedman's statements appeal to me very strongly and remind me of *Future Shock*, a book written by Alvin Toffler in 1970. Toffler defined future shock – which he viewed as destabilizing our society – very simply: "too much change in too short a period of time."

Arthur M. Schlesinger, Jr. discussed the results of economic decline and dissatisfaction in *The Politics of Upheaval* (cited in *The New York Times* of June 20):

> The followers of the demagogues mostly came from the old lower-middle classes, now in an unprecedented stage of frustration and fear, menaced by humiliation, dispossession and poverty. . . . They came from provincial and traditionally non-political groups in the population, jolted from apathy into near-hysteria by the shock of economic collapse. . . . Old America [is] in resentful revolt against contemporary politics and contemporary economics.

These words do an excellent job of summing up current conditions. But Schlesinger, who died in 2007, obviously didn't write them for that purpose, but rather in 1960, to describe the Great Depression. The populism we're seeing today is not a unique phenomenon, but rather a standard occurrence in periods of economic difficulty. Populism has a record of giving rise to very destructive leaders and movements.

The combination of productivity improvements and foreign competition has been very hard on unskilled and semi-skilled labor – what's called "the working class." **People employed in uncompetitive industries at the time globalization takes place are particularly disadvantaged.** Their incomes decline at a minimum, and they may lose their jobs and be unable to find new ones. Society should cushion the blow on these people. Here's one proposal:

> Last March, the ranks of the incensed included 78 percent of Bernie Sanders's supporters and a whopping 98 percent of those backing Donald J. Trump.
>
> More than half of voters – including 61 percent of Mr. Trump's supporters – feel they are not keeping up with the cost of living. Three quarters of Mr. Trump's supporters feel that life for people like them is worse than it was 50 years ago.
>
> **Some of this is due to irreversible forces. The days when white men kept an uncontested hold on political power, when young adults without a college degree could easily find a well-paid job, are not coming back. . . .**

> Last month, four academics – Jeff Madrick from the Century Foundation, Jon Bakija of Williams College, Lane Kenworthy of the University of California, San Diego, and Peter Lindert of the University of California, Davis – published a manual of sorts. It is titled "How Big Should Our Government Be?". . .
>
> The scholars laid out four important tasks: improving the nation's productivity, bolstering workers' economic security, investing in education to close the opportunity deficit of low-income families, and ensuring that Middle America reaps a larger share of the spoils of growth.
>
> The strategy includes more investment in the nation's buckling infrastructure and expanding unemployment and health insurance. It calls for paid sick leave, parental leave and wage insurance for workers who suffer a pay cut when changing jobs. And they argue for more resources for poor families with children and universal early childhood education. (*The International New York Times,* August 3, emphasis added*)*

This is a very liberal agenda, and many Americans would say the whole and many of its parts constitute undesirable government intervention. **What, then – if anything – should be done to arrest the trends described above?** If we don't do something, it's likely that the income and wealth gap will continue to grow; the downside of globalization will continue to be felt; and our political process will continue to be riven by widespread dissatisfaction.

Eduardo Porter, an economics columnist, summed up succinctly in *The New York Times* of May 25:

> We shouldn't try to stop globalization, even if we could. But if we don't do a better job managing a changing world economy, it seems clear that it will end badly . . .

The trends discussed above – and resentment over experiencing them, fear of doing so, and anger upon seeing them at work in one's community – have been big contributors to Trump's popularity over the last year, and also to Sanders's appeal to large numbers of Democratic primary voters. Similar sentiment played a big part in the Brexit vote to Leave and is on the rise in Europe. The issues won't end with this year's presidential election. Rather, I believe they are likely to prove long-lasting and difficult to resolve. They and the non-economic forces at play in this election are likely to have significant influence on U.S. politics for years to come.

<u>The Implications for Politics in the Future</u>

The historical alignment of the two main parties was quite stable for a long time. For most of my life, the Democrats have stood for "the working class"; a bigger and more active government; more taxation, spending and wealth redistribution; and more-liberal social policies. The Republicans, on the other hand, have been considered the party of big business and economically better-off Americans, and they have fought for free enterprise; smaller, less-activist government; lower taxes; a muscular defense posture and foreign intervention; conservative social policies; free trade; and supply-side ("trickle-down") economics. The two parties – and their candidates and voters – generally have stuck to these ideologies.

I've seen the parties evolve from the above positions, but only modestly and gradually:

- The Democratic Party swung toward support for civil rights and became the primary party for non-whites. And when Bill Clinton's administration adopted a more centrist, less-liberal approach, it stood less for welfare and economic redistribution and was more sympathetic to big business and free trade.

- The Republicans, on the other hand, attracted rural whites antagonized by the Democrats' support for desegregation. The party became more motivated by religion, morality and personal freedom, more socially conservative, and less concerned with maintaining military strength and (outside of the Tea Party faction) shrinking government and reforming entitlements.

In the current presidential race, Donald Trump and Bernie Sanders – both outsiders to the traditional parties – have fared quite well thanks to support from millions of voters who are unhappy with the historic political arrangement and how it deals with today's conditions. Thus change appears to have accelerated, and there's talk of political revolution.

Given the events of 2016, the positions described above may well be realigned. There may be a party in the future built largely around:

- economic disadvantage and discontent,
- "cultural grievances" and disregard for political correctness, experts, establishments, and economic, social, political and media elites,
- fear of terrorism, xenophobia, law and order, nativism, protectionism, closed borders, and isolationism, and
- pragmatism and self-interest (national and individual) as opposed to philosophy and ideology.

The above factors, which Trump sums up as "America First" and "Make America Great Again," may well rearrange or supplant the traditional positions of the parties. Depending in part on the outcome of the current election, it may turn out – as many people are saying – that the Republican establishment of the past has lost control of its party. Thus the party described above may be what today is called "Republican," or it may be something brand new. While the Democratic Party establishment remains in control at present, Sanders shook it, assembling a substantial minority attracted to his socialist principles.

It is particularly intriguing to consider the possibility of a reshuffling of the historical blocs into three parties rather than two. Will a party of "the Dissatisfieds" be formed from today's Trump supporters to compete against both the Republicans and the Democrats? Might they be joined by Sanders supporters, with their own dislike of free trade, banks and big money; hostility toward elites and the Washington establishment; preference for economic redistribution; and disappointment with their economic prospects? Can the glue of alienation and dissatisfaction overcome these two groups' vast political, demographic and cultural differences? If Trump loses this year, will this group fade away or become institutionalized under the leadership of more conventional politicians? These things will become clear over time.

Here's a particularly provocative potential issue to consider: Our constitution calls for election of the president by a majority of the electoral college. But if there come to be three major parties, it's easy to imagine no candidate getting a majority. What happens then?

Few Americans may have known the answer a year ago, but I think many have begun to research it, and still more are likely to do so in the years ahead. I'll give you the answer: in the absence of an electoral majority, the president is chosen through a vote of the House of Representatives, with each state having one vote. **Thus, theoretically, the 26 least-populous states – containing just 17% of America's people and, by definition, almost none of its big cities – could choose the president.** For me, regardless of the political makeup of the House, the loss of proportional election is of great concern, particularly given the way the House is elected (see below).

My Prescriptions

I like and admire many of the politicians I meet – of both parties. I just don't like the actions (or inaction) the system produces collectively. So I want to make it clear that my reservations about politicians in general are not as sweeping as I may make them sound above. Here's what I said in "What Worries Me":

> Condemnation of politicians needn't be universal. There actually are some I like. More than anything else, they're marked by a spirit of bipartisanship. Rather than consider politics a blood sport in which the only important goals are to embarrass the other side and win elections, they want to solve our nation's problems.

Nevertheless, despite the above, the bottom line is that I find myself more worried than optimistic (also from "What Worries Me"):

> I confess that I feel the deck is stacked against government getting better. Less attention paid to newspapers and TV news, declining interest in national and international affairs, the rising role of the sound bite, generally shorter attention spans, a vanishing spirit of self-sacrifice, rising me-first-ism . . . where would optimism come from in this regard? We can hope, but I'm not that hopeful. The truth is that most people vote for the candidate who looks and sounds best in TV ads, who says what they want to hear, and who they think will put money in their pocketbooks today and brighten their lives tomorrow.

To the above I would add a very powerful force: the decline of balance in the media. Unlike the days of my youth, in which broadcasters operated under the "fairness doctrine," today there are networks (as well as newspapers and websites) that act more like spokespeople for one party or the other than like impartial journalists. That enables people who follow election news through these outlets to hear only one party's rhetoric and avoid all exposure to the other side's case. This encourages extremism, widens the gulf between people and parties (the statistical evidence in this regard is compelling), and makes bipartisanship less likely.

Can the current political conditions be improved upon? Is the situation hopeless? While the economic and social trends discussed above won't be easily altered, there are some "mechanical" fixes that could make our political process work better.

First, the drawing of district lines for elections to the House of Representatives should be de-politicized. Under the current rules, district lines are redrawn every ten years, after the census, by the party controlling each state's legislature. That means they're able to "gerrymander" the congressional map, drawing the lines so that opposition voters are concentrated into a small number of districts and allowing the party in power to win a disproportionately high number of House seats. Thus, for example, in the 2012 election in Pennsylvania, Democrats received 51% of the votes for the House of Representatives. But, thanks to the way the lines had been drawn by the Republican-dominated state legislature, that 51% majority was crammed mostly into a small number of districts, such that the Democrats won only five (or 28%) of Pennsylvania's eighteen House seats.

As a result of gerrymandering, most House races are easy pickings for the party that drew the lines, and many that remain are equally easy pickings for the opposition party. Thus the vast majority of seats in the House are viewed as "noncompetitive": **there's only one party that can win**.

> The outcome of 94 percent of House races is a foregone conclusion. **If this happened in any country but the U.S., we'd question whether it was a democracy**. (*Christian Science Monitor*, October 14, 2014)

For example, according to *The New York Times*, in the ten years prior to the enactment of the changes in redistricting and primaries described below, congressional seats in California were so safe that in 255 elections, only <u>one</u> shifted from the control of one party to the other.

If the lines for House districts were drawn by independent, non-political committees, I think House members would be less ideological and more likely to compromise, on average, and the process of governing would be less combative and more productive. This process is underway already in my former home state of California. Congressional districts were redrawn by an independent commission in 2011. Although it's too early to judge the results, it appears that the new districts, which follow more natural geographic and demographic boundaries – combined with the new primary system described below – have created races that are more competitive and more inclined toward moderation.

Second, the structure of primaries should be reformed. As described above, district lines usually ensure that a given party will win each House seat. That means in a noncompetitive district, being nominated by the unbeatable party is tantamount to being elected. Thus the real contest today is in the primaries, which are likely to be won by ideologically-zealous candidates. This is so because (a) according to the website *fivethirtyeight*, in 2014 less than 15% of eligible voters participated in congressional primaries, (b) the few who do vote in primaries are likely to be the most motivated, and thus ideological, party members, and (c) gerrymandering has freed the candidate of the inevitable winning party from having to appeal to members of the other party or to independents. This combination encourages extremism.

The results might be different if the rules provided that (a) there's only one primary, in which everyone can vote, and (b) the two top vote-getters in that primary – regardless of party – get to run in the general election. Thus, for example, both of the general election candidates for a House seat in a heavily Republican district could be Republicans, with no Democrat taking up space on the ballot in an election he has no chance to win. In that case, the more moderate of the two Republicans might pick up support from other moderate Republicans (when they turn out in greater numbers in the general election), as well as from Democrats, and be elected to Congress.

This "top-two primary" system is already in place in California, Louisiana and Washington, with the potential to elect moderates rather than extremists. According to *fivethirtyeight*, that's exactly what happened in Washington's 4th district in 2014. A "Tea Party hero" beat out a moderate Republican in the primary, 32% to 26%, while the leading Democrat got only 12% of the vote. In a state with separate Republican and Democratic primaries, the Tea Partier would have run against the Democrat in the general election and been a sure winner. But in Washington, the top two Republicans faced off, and the more moderate candidate won with support from moderate Republicans and some Democrats.

If more moderates won – as was much more common a few decades ago – it would be easier to imagine the two parties working together, producing compromise rather than gridlock. Some people think gridlock is more desirable than government action, but the way I see it, there are serious problems that need solving, and as long as the two houses of Congress are in the hands of extremists from two different parties – or are both led by extremists from a party that's different from the one occupying the White House – solutions are unlikely to be found.

The third improvement would be a reduction in the role of money in politics. Money is everywhere in American politics, and the trends are negative in this regard.

- The 2012 presidential election cost a total of $2 billion, and 2016's may dwarf that.
- The total amount spent on all federal elections in 2012 is estimated at $7 billion.
- Virtually all the cash comes from private interests, rather than public funding as in some other countries. In addition to individual donors, corporations and unions can have great influence.
- Recent court decisions have made it possible for the amounts given to increase and harder for union members to refuse to share in their union's giving. Political giving has been interpreted to be a form of free speech, making it quite difficult to regulate.
- The lobbying industry has over 11,000 members and bills over $3 billion per year.
- Every interest group has its paid lobbyists, especially the ones (like tobacco 50 years ago) that will only maintain profits if they can hold back reforms.

Elected representatives have to drum up contributions in order to fill their war chests. What politician can fail to support his big donors? Thus some may come to serve more as advocates than prudent policymakers.

Several years back I met a young man whom I decided to support in his first House race. When he called me the day after his election, I assumed it was to celebrate and thank me. But instead he asked for a contribution for his next race! With terms of just two years, Congressmen are never not running. This is only one example of the ways in which fundraising is too important in American elections.

I have a fourth suggestion, but fortunately it's one that is superfluous at the Federal level: **avoid the use of referendums to make decisions**. Wisely, the Founding Fathers omitted referendums from the process that governs the U.S. I like to think it was because they knew better than to leave big decisions up to a direct vote of the populace and were worried about "the tyranny of the majority," but it also seems they expected the referendums to occur at the state level.

It's interesting in the current context to note Prime Minister Margaret Thatcher's 1975 opposition to referendums (in defending membership in the European Union against its unpopularity):

> Without the protections and definition afforded by a written constitution, referendums, she said, sacrificed parliamentary sovereignty to political expediency. In a system such as Britain's, that threatened minorities by trading liberal democracy for majoritarianism. "Perhaps the late Lord Attlee was right," she observed, "when he said that the referendum was a device of dictators and demagogues." (*Financial Times*, September 11, 2007)

We just cannot allow a simple majority of those who vote to directly decide important issues like Brexit. First, fewer people vote than we would hope, so decisions can turn on the wishes of a relatively small group. And second, many voters may lack the knowledge and analytical skills necessary for good decision-making. Consider the questions asked most often on Google in the UK in the hours after the Brexit polls closed: "What does it mean to leave the EU?" and "What is the EU?" Presumably many of the people asking these questions were the same ones who had just decided Britain's future. It might have been better if they had asked those questions before the vote.

*   *   *

I wrote this memo to explain what happened in the UK this year and what I think is happening in the U.S. I wanted to point out that politics rarely hews to economic reality; rather, it has a reality all its own.

The recent trends in income, wealth, trade and employment are causing a lot of dissatisfaction in the U.S. and Europe, and I expect them to have a strong impact on politics for years to come. **Widespread economic dislocation can cause voters to choose the wrong leaders. The U.S. is not exempt, and we must be highly vigilant in this regard.**

August 17, 2016

P.S.: Some readers may feel it's wrong for me to make any statements regarding the presidential candidates, and to criticize what I see as Trump's take on economic issues. Others may simply disagree with my views – but they are my views, and I hope you'll feel I have the right to express them. I've tried hard to stick to matters of economics and fact, rather than non-economic policy or programs, opinion or personal preference. I'm sorry if my statements cause unhappiness. Anyone who takes factual issue with anything I say here is welcome to let me know.

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Memo to: Oaktree Clients

From: Howard Marks

Re: Implications of the Election

I'm starting this memo a week before Election Day. I promise to try to stay away from the merits of the candidates and the question of who will win, and instead confine myself to the important messages that we should take away from the election and the actions we should push for as a result. The outcome of tomorrow's election won't change these things as far as I'm concerned.

Angry Voters

Of course, the big story of this election year has been the unprecedented, unconventional rise of Donald Trump. Trump threw his hat into the ring with a complete lack of experience in elected office or other public service, and without an established campaign organization. In fact, he had no established party's ideology. He adopted some Republican elements but rejected others. And yet he has been able to attract a large group of voters, probably about 50 million strong.

He did this by assembling backing from an unusually diverse mix of elements. These included dedicated Republicans who weren't about to vote for a candidate of another party; the many Clinton haters who've had 24 years to gel since Bill's first inauguration; people who were attracted to Trump's celebrity, reputation for business success, outspokenness and colorful manner; and supporters of the right. But this tells only part of the story.

The aspect I consider most important for the future relates to the Trump supporters – and some of the most active and vocal ones – who are motivated by an anger regarding "the system" that is neither purely emotional nor illegitimate.

Many are older, white, non-college-educated men who might be described as "demographically dislocated." When these men were born, white males ran America; their communities weren't mixed and becoming more so; and the cultural shifts occasioned by the civil and women's rights movements, technological change and mass immigration were unimagined. **Certainly the shift to the America of today – with all these things quite different – might be jarring and unpleasant to the people I describe.**

At the same time, many Americans – and often the same ones – are experiencing the effects of job loss and diminished economic prospects. Fifty or even thirty years ago, men without college degrees could easily obtain good-paying jobs and the pride associated with being able to maintain their families at a good standard of living. One earner per household was enough, and one job per earner. Strong labor unions ensured adequate pay and benefits and protected workers from too-rapid changes in work rules and processes.

Now the number of unskilled jobs has been reduced by automation, foreign manufacturing and increased globalization of trade. Unions are much less powerful in the private sector (name a powerful union leader of today who comes to mind). **Men of the sort described above – older, white and non-college-educated – are likely to have lost jobs, know someone who has, or seen the impact on their communities.**

Importantly, until 2000, most Americans felt their children would live better than they did. Now this is no longer true:

> When asked if "life for our children's generation will be better than it has been for us," fully 76 percent said they do not have such confidence. Only 21 percent did. That was the worst ever recorded in the poll; in 2001, 49 percent were confident and 43 percent were not. . . . virtually all polling shows a steep decline in optimism since the late 1990s and early 2000s. (*The Washington Post*, August 12, 2014)

Here's a quote from Thomas Friedman in *The International New York Times* of June 30 that I used to sum up in "Political Reality" (August 2016). As I wrote there, I think it does a great job of capturing the situation:

> It's the story of our time: **The pace of change in technology, globalization and climate have started to outrun the ability of our political systems to build the social, educational, community, workplace and political innovations needed for some citizens to keep up.**
>
> We have globalized trade and manufacturing, and we have introduced robots and artificial intelligent systems, far faster than we have designed the social safety nets, trade surge protectors and educational advancement options that would allow people caught in this transition to have the time, space and tools to thrive. It's left a lot of people dizzy and dislocated.

What we have is a country – in fact, a world – that is changing rapidly and in ways that are unpleasant and disorienting for large segments of the population. The present is different from the past, and the future looks worse than it used to. Slower economic growth is producing less opportunity overall, and a number of forces are supplementing slow growth in diminishing the outlook. Rising income inequality is directing an increasing share of the gains to top earners. Older people lacking higher education are particularly ill-equipped to deal with the changes.

I think this is an apt description of conditions in the U.S., but it seems equally applicable to much of the developed world. In an opinion piece on October 26, starting from the German point of view, Jochen Bittner of the *International New York Times* described a broad group he called Wutbürgers, or "angry citizens." I think they're rising everywhere:

> It is a relatively new expression, with a derogatory connotation. A Wutbürger rages against a new train station and tilts against wind turbines. Wutbürgers came out in protest after the Berlin government decided to bail out Greece and to accept roughly one million refugees and migrants into Germany.
>
> Wutbürgers lie at both ends of the political spectrum; they flock to the right-wing Alternative für Deutschland and the socialist Linke (Left) Party. The left wing has long had a place in German politics, and the Linke has deep roots in the former East Germany's ruling party. And we've had a fringe right wing since the postwar period began. But the populist anger of the A.F.D. is something new: Anti-establishment, anti-European Union and anti-globalization. . . .
>
> The same thing is happening elsewhere in Europe: Many British Wutbürgers voted for Brexit. French Wutbürgers will vote for Marine Le Pen's National Front. Perhaps the most powerful Wutbürger of them all is Donald J. Trump.

Which raises the question: How was anger hijacked?

In its pure form, anger is a wonderful force of change. Just imagine a world without anger. In Germany, without the anger of the labor movement, we would still have a class-based voting system that privileged the wealthy, and workers would still toil 16 hours a day without pension rights. Britain and France would still be ruled by absolute monarchs. The Iron Curtain would still divide Europe, the United States would still be a British colony and its slaves could only dream of casting a vote this Nov. 8.

Karl Marx was a Wutbürger. So were Montesquieu [who articulated the concept of separation of powers within a government], William Wilberforce [the leader of the abolitionist movement in Britain], the Rev. Dr. Martin Luther King Jr. and the tens of thousands of Eastern German protesters who brought down the Berlin Wall in 1989. . . .

Now: Compare these spirits to the current parties claiming to stand for necessary change. . . . Sadly, the leaders of today's Wutbürger movements never grasped the difference between anger driven by righteousness and anger driven by hate.

Anger works like gasoline. If you use it intelligently and in a controlled manner, you can move the world. That's called progress. Or you just spill it about and ignite it, creating spectacular explosions. That's called arson.

Unfortunately, this lack of maturity and prudence today exists among not just the new populist class, but parts of the political establishment. The governing class needs to understand that just because people are embittered and paranoid doesn't mean they don't have a case. **A growing number of voters are going into meltdown because they believe that politicians – and journalists – don't see what they see. . . .**

The grievances of white, often less-educated voters on both sides of the Atlantic are often dismissed as xenophobic, simplistic hillbillyism. But doing so comes at a cost. Europe's traditional source of social change, its social democrats, appear to just not get it. When Hillary Clinton calls half of Mr. Trump's voters a "basket of deplorables," she sounds as aloof as Marie Antoinette, telling French subjects who had no bread to "eat cake."

. . . Amid their mutual finger-pointing, neither populist nor established parties acknowledge that both are squandering people's anger, either by turning this anger into counter-productive hatred or by denouncing and dismissing it. Mrs. Clinton [making the presumption that she would win, as seemed clear on October 26] has the chance to change, by leading a political establishment that examines and processes anger instead of merely producing and dismissing it. If she does, let's hope Europe once again looks to America as a model for democracy. (Emphasis added)

The point of all of this is that Trump is importantly supported by dislocated, disoriented voters who are angry about a number of unquestionably significant trends that are impacting them and their communities. Regardless of the outcome of the election, they and their sentiments will remain a powerful force.

Here's how I concluded the relevant section of "Political Reality." I'll let it do the same here:

> **What, then – if anything – should be done to arrest the trends described above?** If we don't do something, it's likely that the income and wealth gap will continue to grow; the downside of globalization will continue to be felt; and our political process will continue to be riven by widespread dissatisfaction.
>
> Eduardo Porter, an economics columnist, summed up succinctly in *The New York Times* of May 25:
>
>> We shouldn't try to stop globalization, even if we could. But if we don't do a better job managing a changing world economy, it seems clear that it will end badly . . .
>
> **The trends discussed above – and resentment over experiencing them, fear of doing so, and anger upon seeing them at work in one's community – have been big contributors to Trump's popularity over the last year, and also to Sanders's appeal to large numbers of Democratic primary voters. Similar sentiment played a big part in the Brexit vote to Leave and is on the rise in Europe. The issues won't end with this year's presidential election.** Rather, I believe they are likely to prove long-lasting and difficult to resolve. They and the non-economic forces at play in this election are likely to have significant influence on U.S. politics for years to come.

<u>A Call to Action</u>

As Bittner wrote, voter anger can be a potentially-powerful force for change. It is my hope that the presence of this anger will make it clear to our elected leaders that change is needed, rather than that they should dig in their heels further to fight the opposing party.

As I recall, it was in the 1980s that a massive ideological gulf opened between the Democrats and Republicans, with the liberal views Carter had espoused while in office (1976-80) contrasting sharply with the strict conservative philosophy Reagan brought to his presidency (1980-88). After the quieter presidency of Bush the Elder, Bill Clinton held office in 1992-2000, and the attitude of the right approached revulsion, whether based on his liberal agenda or his personal conduct. Very negative feelings also befell George W. Bush in 2000-08 (who was named president after an election decided by the Supreme Court, and who took us into war in the Middle East) and Barack Obama in the last eight years (with what the right considered his overreaching plan for health care).

Over the last 36 years, then, politicians have become more combative and less willing to compromise – and certainly unwilling to take their lead from the occupant of the White House if he's from the other party. It often seems the members of both parties have devoted themselves primarily to denying the other any accomplishment. And in our system of government – where the two houses of Congress and the presidency can be under the control of different parties, and where in the Senate it can take 60 votes out of 100 (not 51) to advance legislation – it's easy to prevent progress. The result has been gridlock and a total lack of forward movement.

Some people – and especially conservatives who think the size and role of government should be limited, and libertarians who generally oppose "coercive institutions" – think gridlock is a good thing. They think the less government does, the better. This was a particularly popular sentiment around the time of the Reagan presidency, when conservative ideology was in its heyday.

But we cannot cope in this complex, rapidly changing world without some solutions. Inaction can't always be depended on, especially given that we're not starting from the ground zero of virgin territory. Government has taken action in the past – for example, setting the rules for Social Security – and it legitimately may have to rewrite those rules when circumstances change: when there are fewer people working per retiree, or when people live longer. You can't say "I prefer gridlock" and assume the system will remain solvent.

We need good decisions made and action taken on not just Social Security and other entitlements, but also the health care system, trade agreements, infrastructure spending and other fiscal stimulus, our defense posture and – yes – appointments to the Supreme Court. This year, Republicans refused to deal with President Obama's nominee to fill a Court vacancy. That vacancy will remain for the new president to fill, and two to three more are likely to open up in the next four years. Will they be dealt with constructively – by whichever party doesn't occupy the White House? Or will there be continued obstructionism and a lack of decision making.

The writer of the 2014 *Washington Post* piece cited above, regarding diminished optimism, attributes some of this to the slowness of the economic recovery since the financial crisis of 2008, and some to increasing inequality, meaning fewer and fewer people are participating in the gains. And then she goes on to cite another possible reason:

> The lost optimism, [Fred Yang, a Democratic pollster] said, "says a lot about how shaken we are by the inability of our political system to address seemingly easy issues, and it leaves us worried about the future."
>
> Yang doesn't see that improving much, even as the economy does. "The unsettledness of the public is what is normal now," he said. "To me, this is less about economic reality than about our political system — our lack of confidence that our political leaders, regardless of party, are equipped to deal with the future."

Thus I believe that citizens are angry not just because of recent trends, but also because the government hasn't done enough to stem them or lessen their impact. Even a "conservative" who favors a limited role for government may want some action taken if he has lost his job due to globalization or automation. **Trump promised to help, and it has won him a lot of votes.**

It is my hope that constructive action will be taken. Here's what Blackstone founder and former Secretary of Commerce Pete Peterson wrote in his book *Running on Empty*:

> . . . while our problems are not yet intractable, both political parties are increasingly incorrigible. They are not facing our problems, they are running from them. They are locked into a politics of denial, distraction, and self-indulgence that can only be overcome if readers like you take back this country from the ideologues and spin doctors of both the left and the right. . . .
>
> With faith-driven catechisms that are largely impervious to analysis or evidence, and that seem removed from any kind of serious political morality, both political parties have formed an unholy alliance – an undeclared war on the future. An undeclared war, that is, on our children. **From neither party do we hear anything about sacrificing today for a better tomorrow. In some ways, our most formidable challenge may be our leaders' baffling indifference to our fiscal metastasis**. As former Treasury Secretary Larry Summers puts it, "The only thing we have to fear is the lack of fear itself." (Emphasis added)

The Importance of Bipartisanship

I think we're on the way to a geometry proof (remember high school?).

- The voters are angry about the level of government inaction.
- Positive steps must be taken if we're to solve today's pressing problems.

So what's the next step, the next essential ingredient? To me, it's bipartisan compromise.

When I was a kid, the leaders of the two parties in Congress worked with the president to solve problems and achieve legislative compromise. Here's what I wrote on this subject in "A Fresh Start (Hopefully)," after the last election in 2012:

> The opposite of gridlock is compromise. That's what we need today. **Compromise, however, doesn't mean one party saying "We get all we want and you get none of what you want."** Deals like that can only be inked if one party holds all the cards: either the White House plus majorities in both the Senate (and preferably the 60 votes required to stop a filibuster) and the House of Representatives or, at minimum, majorities in both houses of Congress and enough votes to override a presidential veto. Both parties are far from that today, and that may remain the case for a long time.
>
> **No, compromise means, "We get some of what we want and you get some of what you want." In practice, it means elected officials have to vote for things they promised to fight and give up on things they swore to deliver.** Unless you do that, the other guy doesn't get any of what he wants – meaning he has no reason to go along. This is a reality that our political leaders have failed to confront and accept.
>
> While compromise comes at a cost, gridlock can cost more. Last year, some long-term U.S. debt was downgraded after a particularly unseemly battle over the federal debt ceiling. This occurred not so much because of our fiscal situation, but because our dysfunctional government showed itself to be unable to rise to the occasion and solve problems. . . .
>
> On November 7, *The New York Times* carried an excellent article by Thomas L. Friedman entitled "Hope and Change, Part II." In it, Friedman did a great job of outlining some of the things Washington will have to do in order for the outlook to improve.
>
>> The next generation is going to need immigration of high-I.Q. risk-takers from India, China and Latin America if the United States is going to remain at the cutting edge of the Information Technology revolution and be able to afford the government we want. . . .
>>
>> . . . my prediction is that the biggest domestic issue in the next four years will be how we respond to changes in technology, globalization and markets that have, in a very short space of time, made the decent-wage, middle-skilled job – the backbone of the middle class – increasingly obsolete. The only decent-wage jobs will be high-skilled ones.
>>
>> The answer to that challenge will require a new level of political imagination – a combination of educational reforms and unprecedented collaboration between business, schools, universities and government to change how workers are

> trained and empowered to keep learning. It will require tax reforms and immigration reforms. America today desperately needs a center-right Republican party offering merit-based, market-based approaches to all these issues – and a willingness to meet the other side halfway. The country is starved for practical, bipartisan cooperation, and it will reward politicians who deliver it and punish those who don't. . . .

I'm frustrated when I see Americans of both parties failing to punish – or even encouraging – behavior on the part of their elected officials that is fractious, partisan, ideological and non-compromising. Gridlock and inaction won't solve our problems. Cooperation, adaptability and Friedman's "imagination" must be the watchwords for the years ahead.

We need constructive action to solve the many problems we face, and there's only one way for it to materialize: bipartisanship.

Flaws in Our Democracy

There's a good chance that this year's election result will demonstrate the presence of elements capable of rendering our elections less than perfectly democratic. The main culprit is the Electoral College. Here's more from "A Fresh Start" in 2012:

> How did the "too close to call" headlines of the days just before the election turn into a resounding victory, which the Democrats will argue has given them a mandate to lead? How did Obama's small edge in the popular vote turn into a 62%-38% margin in terms of the electoral votes that determine the winner? The answer lies in the peculiarities of our electoral college.
>
> I was traveling in Asia and the Middle East at election time, and I found myself having to explain a system in which:
>
> - In all but a few states, 100% of the electoral votes go to whoever wins the popular vote there, regardless of the margin.
> - Most of the 50 states – this year it was roughly 43 – are considered "uncompetitive," meaning one party or the other enjoys a substantial, dependable majority. For that reason, a vote for a Republican is totally meaningless in a Democratic state like California, as is a vote for a Democrat in Republican Utah.
> - On the other hand, the electoral system gives voters in a few states disproportionate influence. Since the uncompetitive states' electoral votes are not in play, elections are determined by only the few so-called "swing" or "battleground" states. In fact, this year many people thought the election might be determined largely by who won in just one state: Ohio.
> - Perhaps most glaringly, a candidate can be elected president with a majority of electoral votes despite having received fewer popular votes than another.
>
> Our system was designed in the eighteenth century to centralize the job of choosing a president in the hands of a few wise leaders and avoid the uncertainties associated with a widespread and uninformed populace with which it was hard to communicate.

> But in the twenty-first century, with the impediments to a meaningful popular election much reduced, it's time to reassess the benefits of the electoral college – it's hard to say what they are – versus the costs in terms of potentially weird outcomes. **In the days just before the election, it seemed that for the second time in twelve years we could have a president who'd lost the popular vote. That tells me it's time to reassess our system of voting.**

The existence of the Electoral College can lead to other possible complications. In "Political Reality" in August, I raised the question of what happens if no candidate receives a majority of the 538 electoral votes:

> I'll give you the answer: in the absence of an electoral majority, the president is chosen through a vote of the House of Representatives, with each state having one vote. **Thus, theoretically, the 26 least-populous states – containing just 17% of America's people and, by definition, almost none of its big cities – could choose the president.** For me, regardless of the political makeup of the House, the loss of proportional election is of great concern . . .

Lastly under this heading, I want to touch on the role of money. In our elections (a) the vast bulk of campaign funding is provided privately, not publicly, and (b) the Supreme Court has ruled, in effect, that the amounts donated largely cannot be limited. The result, in my view, approaches the undoing of "one man, one vote." While each person's actual vote is the same, his or her influence on the outcome is not. Here are just a few data points, according to *Business Insider* (October 31):

- Nearly $6.6 billion is the amount candidates, parties, and outside groups are raising and spending in trying to move things their way in the 2016 election cycle, the Center for Responsive Politics estimates on its website, OpenSecrets.org. It's a new record. It's up by $86.5 million, adjusted for inflation, from the 2012 presidential cycle, which had also been a record.
- The biggest increases in money flows, compared to 2012, came from outside money groups "that purportedly work independently from candidates," the report said. They've greased this election with $1.3 billion so far (through October 24), $190 million more than at this point in 2012, accounting for 26.8% of total spending.
- And it's getting more concentrated: "The top 100 families" contributed $654 million to candidates, political parties, and outside groups so far, or 11.9% of the total raised, up from 5.6% in the 2012 election cycle.
- The top ten families have given a total of $281 million so far this year.

It wasn't many years ago that contributions were limited to a couple of thousand dollars per candidate per race. Now $100,000 isn't an uncommon ask, and there are legitimate (but possibly cynical) ways to donate millions. Given the amounts involved and the private sourcing, I find it hard to believe that elected officials are able to entirely ignore donors' interests and preferences when they do their jobs. I'm not talking about corruption, just a not-quite-level playing field. This area is ripe for change. But given that the Supreme Court ruled that political donations are "speech" and thus can't be regulated, change would require a constitutional amendment or a different decision from the Supreme Court.

<u>The Outlook for the Parties</u>

One thing that's uncertain as we move forward from here is what the future holds for the two main parties.

Many voters crossed long-standing party lines during this campaign:

- Working class Americans, traditionally Democrats, were attracted to Trump by his anti-establishment, non-politically-correct, "Make America Great Again" approach.
- Big business, traditionally Republican, failed to support Trump, perhaps because of his anti-trade positions – even though he might well be a more pro-business president than Clinton.
- College-educated white Republicans – and especially women among them – backed Clinton, presumably because of Trump's controversial behavior and Clinton's role as the first woman candidate.

Will these new party allegiances hold? Or, if they arose largely because voters felt either attracted to or repelled by one of the 2016 candidates, will some or all of these developments reverse when the candidates are different?

The leaders of both parties were challenged this year by angry members. Will those members stay with their parties, or will they be less rooted in the future and "up for grabs"? **The make-up – and the cohesiveness – of both parties is in flux, and thus the next election may be another that deviates from the usual path.**

The Democrats have their issues. It's one of Trump's assertions that the Democratic party has been taking its working class members for granted, talking up the connection at election time but failing to come through with solutions, especially for displaced workers. (Democrats will counter that it's because Republicans have been successful in implementing gridlock so as to stymy programs like retraining.) The fight between moderates and liberals for control of the Democratic party – made clear in the divided primary results between Clinton and Sanders – is far from over. Sanders supporters may decide that the party leadership isn't liberal enough.

But I think it's the Republican party that faces greater challenges. Over the last few decades, the party has been thrown together from largely unrelated and disjointed elements. As I described in "Political Reality," the traditional Republicans of 60 years ago – fiscally responsible, pro-business, socially moderate and strong on defense – have been joined more recently by conservatives, the Tea Party, Evangelical Christians, anti-gun-control voters, anti-abortion groups, and now the economically dislocated. The glue is weak; rather than by ideology, they have been unified primarily by the fight against Democrats.

Will all these groups stay within the party? Perhaps some of the last will "vote with their feet" with regard to House Speaker and party leader Paul Ryan, who first refused to endorse Trump, then did endorse him, then described Trump's raunchy 2005 video as "troubling" and said he wouldn't campaign for him or support him, and then voted for him and expressed support but did so – pointedly? – without mentioning his name. After Ryan responded to the video by disinviting Trump from a joint campaign event in his home state of Wisconsin, he was booed by some in the crowd. Will Trump supporters remain Republicans if Ryan continues to lead the party? Will Trump supporters elected to the House support Ryan in his leadership of their caucus?

Ryan's experience wasn't unique: numerous Republican politicians had problems with Trump's policies or actions but needed his supporters, who constitute a large part of Republican voters. The conflict between principle and pragmatism is very real, and the painfulness of their dilemma has been clear. It has produced flip-flopping and confusing stances (raising the question of whether it's possible to support a candidate but not endorse him).

If Trump's supporters desert the Republican party (or the political process) due to disenchantment with the behavior of its leaders, the party may have a hard time pulling together a meaningful following in future elections.

> "Trump has essentially run as an outsider who staged a hostile takeover of the Republican party. If he loses, as is expected, he will still have won the votes of some 50 million voters or more, and they will represent a continuing, potent force, roiling with resentments," said [David Gergen, an adviser to four presidents – three of them Republicans]. "Before Donald Trump brought his wrecking ball to the party, one might have thought it highly likely that Republicans could unite after yet another losing election. But one of Trump's many ugly legacies is that the chances of the party losing its coherence – or even breaking up – now seems better than 50:50. (*Financial Times*, October 29/30 – clearly not a Democratic, or even an American, publication)

The Republicans' plan after the defeat of Mitt Romney in 2012 centered around increasing its appeal to women and Hispanics and other minorities. In this campaign, however, that effort probably went into reverse.

I think the Republican party faces real issues. And my point here is that **our country needs two strong parties, not an elected dictatorship. With two strong parties there can be an active debate of ideas, and neither is able to operate unopposed in a Washington devoid of meaningful resistance. The complete opposite of gridlock – free rein – isn't desirable either.**

* * *

On November 2, John Cassidy wrote in *The New Yorker* of:

> . . . an America bitterly divided along class, racial, and cultural lines. To quote Benjamin Disraeli, the nineteenth-century British statesman, we now have "two nations between whom there is no intercourse and no sympathy; who are as ignorant of each other's habits, thoughts, and feelings, as if they were dwellers in different zones, or inhabitants of different planets."
>
> Disraeli was writing about the rapidly industrializing England of the eighteen-forties, and the two nations he referred to were the rich and the poor. In the United States, because of its history of slavery, the Civil War, and mass immigration, the divisions have never been that simple: vertical cleavages along racial, ethnic, and regional lines have often trumped the horizontal class divide. But the gulf between Clinton's America and Trump's America, even though it can't be traced entirely along economic lines, is now a yawning chasm.

It's very much worth noting that the electoral map showing who's expected to win which states has the West Coast, the Northeast and the Upper Midwest quite solid for Clinton and a broad swath down the middle of the country for Trump. The regions' differences from each other are very significant, with the people in Trump country more likely to live rural lives, to have been born in the U.S. (and often in the same town in which they now live), and to have worked in manufacturing. These differences contribute to the divide described above.

The political arena this year seems like a battlefield, divided much more than usual by antagonism, incivility, anger and downright hatred. Elites, establishments, experts, incumbents, insiders, internationalists and political correctness all came under attack, with no one to defend them. Slow economic growth – accentuated by continuing automation and international trade – is likely to continue to leave dissatisfaction within the working class. And after having seen behavioral norms wiped away in the first x-rated campaign – and doubts raised about the impartiality of the FBI and even the fairness of our elections – large numbers of people may be left alienated. **When the election is over, these things are likely to remain the case.**

But as I look forward, I see the need for constructive, bipartisan governmental action. Is that wishful thinking? Winning future elections could become a function of producing solutions, and that in turn could lead to cooperation and compromise between the two parties. I'll use a rarely seen word to describe my dream: comity. Its definition makes it perfect for this use: "courtesy and considerate behavior toward others."

The environment described above doesn't feel like one that encourages comity or one in which the parties can function internally and work together. Therefore we might have to hope that politicians will conclude not only that the future of the country requires bipartisanship, but that their own success does as well.

Unlikely? Perhaps. But after a post-election memo in 2012 that proved far too optimistic, I say, "why quit now?"

November 7, 2016

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Memo to: Oaktree Clients

From: Howard Marks

Re: Go Figure!

Think back to just before last week's election. What did we know?

- The polls were almost unanimous in saying Hillary Clinton would win the popular vote by about 3%.
- FiveThirtyEight, an analytical website whose forecasts had proved quite accurate in the two prior presidential elections, gave Clinton a 71% probability of winning, and almost everyone else was between 80% and 90%.
- Clinton was favored in most of the "swing states" that would make the difference in the Electoral College. Thus she was expected to win more than 290 electoral votes, leaving just 250 or so for Donald Trump.
- Clinton was the obvious choice of the people who move the markets. This could be seen in the fact that the markets went up when Clinton's odds improved in late October (recovering from some unpleasant Wikileaks disclosures), and then they fell after the FBI's James Comey announced the discovery of an additional cache of Clinton emails on October 28, lifting Trump's chances.
- Thus there was a near-universal belief that a Trump victory – as unlikely as it was – would be bad for the markets.

So what happened? **First Clinton didn't win.** There's much soul-searching, particularly among the forecasting fraternity. Everyone knew intellectually that Trump had a non-zero chance of winning, but few people thought it could actually happen.

And second, the U.S. stock market had its best week since 2014! The Dow Jones Industrials rose almost 5% for the week, taking them to a new all-time high. The Dow was up every day last week. It rose on Monday and Tuesday, when Clinton was expected to win. And then it rose Wednesday, Thursday and Friday, after she had lost.

That behavior calls to mind my January memo, "On the Couch," on the subject of the market's irrationality. Clearly, the election was the biggest event last week, so it must have been the main influence behind the changes in stock prices. But how could the expectation of a Clinton victory make stock prices rise, and then the reality of her defeat make them rise further?

In that memo, I included a cartoon showing a newscaster saying, "Everything that was good for the market yesterday was no good for it today." In the case of the election, it might have been, "Whatever was good for the market yesterday, its polar opposite was good for it today." It just doesn't make sense.

While people search the market's behavior for logic, there really doesn't have to be any. In "On the Couch," I mentioned that sometimes the market interprets everything positively, and sometimes it interprets everything negatively. The market often fails to act rationally in the short run, primarily because of the role played by people in determining its course.

Thus two key observations can be made based on last week's developments:

- First, no one really knows what events are going to transpire.
- And second, no one knows what the market's reaction to those events will be.

These observations reinforce my belief that it's a mistake to base investment decisions on macro forecasts. But you knew that.

Impact on the Markets

Of course there's logic to the market's rise last week, just a logic different from that which would have made it go up if Clinton had won. The reasons one might cite are these:

- **As a businessman, Trump doubtless intends to be a pro-business president.** In fact, he'll probably make more of an effort to nurture business than Clinton would have (especially when being pushed to the left by Sanders and Elizabeth Warren), and more than I think characterized the Obama administration.
- Trump's campaign promises have included tax reform; reduced income tax rates on corporations and big earners; some form of tax holiday to enable corporations to bring in profits stranded abroad; a reduction of business regulation (Carl Icahn tells me this will be huge); a big infrastructure program ($1 trillion announced); an end to bank-bashing; less pressure on pharmaceutical and health care companies to cut prices; and an end to the estate tax. That's quite a pro-business agenda.
- The populist power of Sen. Warren will be reduced.
- Businessmen and Wall Streeters will be welcome to serve in the administration, not verboten as in recent years.

At the bottom line – if everything works as promised – there will be massive fiscal stimulus; big increases in GDP growth, corporate profits and jobs; higher inflation than otherwise would have been the case; a big increase in the national debt; and more of everything for everybody.

> Writing in the Financial Times, Anthony Scaramucci, a member of Mr. Trump's economic advisory council, said the president-elect would finance the new spending plan with "historically-cheap debt and public-private partnerships" and said it would cut deficits by stimulating economic growth. "Economies around the world are fighting deflation largely because of a post-crisis move toward fiscal austerity. We can close the wealth gap in America by replacing emergency-level interest rates with fiscal stimulus." (*Financial Times*, November 12-13)

No austerity here!

Trump's statements regarding business and the economy contain some real positives and are the best part of his platform . . . if he and his administration are up to the task of putting them into practice.

However, some of his promises may test the limits of what can be accomplished under the limitations imposed by economic reality.

And there are negatives, including:

- Trump's express disdain for Janet Yellen, and the resulting possibility that Fed independence will be reduced,
- his stance on international trade pacts (an area in which a president has unusually broad power to take unilateral action), his threat of imposing import duties on goods made in China and Mexico, and the resulting possibility of trade wars, and
- the possibility that this plus his unconventional positions on things such as climate change and defense treaties bode ill for international relations in general.

That brings us to the outlook for bonds. Just as the U.S. stock market has celebrated Trump's election, the bond markets have been discouraged. Interest rates rose very rapidly last week following Trump's election, bringing big losses to bond holders. The *FT* wrote the following, citing Henry Kaufman, the Salomon Brothers chief economist who correctly called the bond bear market in the 1970s:

> "It's a tectonic shift" . . . the end of a three-decade bond bull market, because of the likelihood of unfunded tax cuts, infrastructure spending and a radically reshaped Federal Reserve. "I would say the secular trend is going to be upwards now," he told the FT. "Secular swings are hard to forecast, but the secular sweep downwards in interest rates is over, and we are about to have a gentle swing upwards."

I always feel it takes a degree of innate optimism to be a devotee of stocks (with their reliance on conjectural returns awarded by the market) as opposed to bonds (which bring contractual returns guaranteed by their issuers). Thus U.S. equity investors have exhibited an optimism regarding the Trump administration that virtually no one foresaw a week ago.

Equity investors like inflation because it pumps up profits. Bond investors dislike it because it raises interest rates, reducing the value of the bonds they hold. But the two can't go in opposite directions forever. At some distant point, higher interest rates can cause bonds to offer stiffer competition against highly appreciated stocks.

Finally on the subject of the market outlook, I'll pass on some observations from Stanley Druckenmiller – the owner of one of the very best investment records in history, and certainly not someone congenitally biased to optimism (or anything else):

> Billionaire investor Stanley Druckenmiller told CNBC on Thursday he's "quite, quite optimistic" about the U.S. economy following the election of Donald Trump.
>
> "I sold all my gold on the night of the election," the founder and former chairman of Duquesne Capital said in a "Squawk Box" interview.

> He said he's betting on growth by shorting bonds globally, and he likes stocks that respond to growth. He also likes prospects for the dollar, especially against the euro.
>
> This rosier outlook is in sharp contrast to what Druckenmiller said at the Sohn Investment Conference in New York in May. At the time, he told attendees they should sell their stock holdings. He also had said gold was his "largest currency allocation."
>
> Despite Druckenmiller's past negativity, he said Thursday: "It's as hopeful as I've been in a long time." He added, "I would not be surprised if we're not looking at the peak of the divisiveness."
>
> "[But] I hope economic policy is deferred to Mike Pence and Paul Ryan," he said, referring to the vice president-elect and the speaker of the House. He pointed out he did not support Hillary Clinton. (Druckenmiller had supported John Kasich for the Republican nomination and said he's philosophically in favor of Ryan's economic policies.)
>
> "I don't think Donald Trump is Ronald Reagan," he added.
>
> Since Republicans maintained control of the House and Senate while winning the White House, Druckenmiller said "this is the greatest chance" to get tax reform and deregulation passed.
>
> "If it wasn't for the messy conflict of rates rising with the stronger economic growth through [fiscal] policy, I would think there's so much low-hanging fruit in terms of deregulation and tax reform, we could get a jolt of 4 percent [growth] for about 18 months," he said.
>
> "I do think interest rates could cut that back into the high 2s, low 3s [percent]," he continued, adding markets are pointing to the cost of borrowing money going up a lot. "I think the market is going to force this. The market is going to push them to raise interest rates if my hopeful scenario turns out to be right." (CNBC on-line)

I usually inveigh against macro forecasting and macro investing, but Stan is the exception who proves I'm far from 100% right. I supply his words unabridged. No one should ignore them.

<u>Why Were the Forecasters So Wrong?</u>

Trump won in 30 states, whereas Clinton won in 20 states and the District of Columbia. Trump won in three states that were expected to go for Clinton plus the two largest of the three states rated "toss-ups," while Clinton didn't upset Trump in any of the states people expected him to win. Trump won vastly more counties than Clinton (although not the most populated, obviously), including those populated by both below-average and above-average incomes. Many of these things came as surprises.

The amalgamation of Trump voters that I described in "Implications of the Election" came together as expected, but in greater quantity than expected. His supporters were moved by great fervor, and while they may not have admitted to the pollsters that they favored the candidate derided by most of the media and intelligentsia, they voted for him in surprising numbers. The surprises included some college-educated whites, people with higher incomes, and even Hispanics, the vast majority of whom were expected to vote for Clinton.

And in the end, the "enthusiasm deficit" people had talked about all campaign came home to haunt Clinton. While more people had told pollsters they would vote for her than for Trump, many of them were probably motivated by aversion to Trump rather than any great love of Clinton. In the end, her voters' lack of enthusiasm seems to have kept enough from the polls to make the difference. Turnout was below expectations in Florida, Michigan, Pennsylvania and Wisconsin, and the results in these states were largely responsible for the election surprise.

The *Financial Times* of November 12-13 made a telling observation:

> In Michigan and Wisconsin, the two states that arguably swung the election, [Mrs. Clinton] received roughly 300,000 fewer votes than Mr. Obama did, suggesting his supporters either stayed home, or cast their votes for Mr. Trump or a third-party candidate.

The bottom line is that Trump won virtually all the counties that Romney won in 2012 plus a fair number of the ones Obama won. Clinton lost Pennsylvania by 1.4%, whereas two weeks ago she was thought to be ahead by double digits; Wisconsin by 1.5%, a state she was expected to win; and Michigan by 0.3%, a state Obama carried in 2012.

Obama's supporters were passionate, often because of his stirring oratory and/or his potential to be/remain the first black president. Despite the possibility of her being the first woman in the White House, Clinton ran into trouble relating to her difficulty connecting with the "common man," in addition to the controversies relating to her private email server and the Clinton Foundation. Finally, she never picked up some of the Democrats, especially young ones, who had coalesced behind Bernie Sanders's more liberal agenda. Thus her vote count fell short of expectations.

A combined shortfall of just 113,000 votes in Pennsylvania, Wisconsin and Michigan made Clinton the loser. If she had won just 57,000 of those votes (or 0.4% of the 13.6 million total votes cast there), she would be the president-elect.

For whatever reason, Trump, who almost everyone thought had no significant chance, was the surprise winner. After this and the Brexit vote – which also ran counter to forecasts – prognosticators are likely to be followed less assiduously in the future than in the past.

I keep saying "almost everyone" thought Clinton would win. That's because there was one prominent exception: the USC Dornslife/Los Angeles Times Presidential Election Poll consistently predicted a Trump victory in the popular vote. They had him up by 3% at the end.

Now the USC poll's Arie Kapteyn is being lauded for having gotten the outcome right, and Bloomberg reports that he employed "what experts called a unique and more complex weighting model." Does his success redeem the forecasting profession?

Not really. Trump didn't win the popular vote as USC predicted; he lost it (by just under half a percent). Thus you can't say USC had it right. They were wrong. Or rather, they were right about a Trump victory, but for the wrong reason. (How often do we see that in the investment world?) In the end, who was more right: USC (which said he would win the popular vote) or the others (who were correct in saying Clinton would win it – only to see her lose the election)? That's what I would call a Talebian question.

The bottom line is that popular vote polls get headlines, but the presidency is determined in the Electoral College. The latter made Trump the winner – as USC had said, but not for the reason it had predicted. (More on the Electoral College later.)

<u>Outlook for the Trump Presidency</u>

I was in Australia on Election Day, and right away I was asked what the future holds. First, I said, there's far too much we don't know to permit any conclusions. Here are a few of the key open questions:

- How much of what Trump said while campaigning did he mean?
- How much of what he actually meant will he try to implement?
- And how much of what he tries to implement will he be able to effect?

- Will he seek advice? (While campaigning he gave the impression he thinks he knows best.)
- Will he appoint expert, experienced advisors?
- Will he heed their advice?

Second, I'd look for some initial signs.

- Would his acceptance speech be conciliatory or vindictive? Certainly it was the former.
- Will his first appointments be constructive or less so? Will they primarily reward loyalty or expertise and experience?
    - We can take some encouragement from the mainstream choice of Mike Pence to head his transition team.
    - Less cheering is his appointment of Myron Ebell, an outspoken climate change denier, to lead the transition at the Environmental Protection Agency.
    - I had thought that Trump's selection of his chief of staff would be somewhat telling, given the rumored choice between the controversial campaign adviser Steve Bannon, formerly head of the alt-right Breitbart News, and Republican National Committee Chair Reince Priebus, who is respected in Washington and has an insider's understanding of how it works. Sunday's appointment of Priebus as chief of staff and Bannon as chief strategist/senior counselor leaves the question unanswered and suggests there's room in the Trump administration for both traditionalists and outsiders.
    - One of the things we have yet to see is whether experienced and respected veterans of government will join an unpredictable and potentially controversial administration.
- Will Trump's early behavior indicate that the man we saw on the stump was the real Trump, or that the fiery populist and outside-the-box persona was exaggerated for effect? I am

somewhat encouraged that, so far, he's appearing about as "presidential" as we could have thought possible.

Third, it will be interesting to see the extent to which Trump is supported in Congress. Republicans lost a net of six seats in the House of Representatives, but they still enjoy a solid majority of 45 seats out of the 435 there.

But they lost some ground in the Senate and thus now hold only a bare majority of the 100 seats. Here are some of the key considerations there:

- The Senate has a special role, as its approval is required for treaties (a two-thirds majority) and for appointments such as those of cabinet members, ambassadors, and judges of the Supreme Court.
- Certainly some candidates ran for the Senate this year – and won – explicitly rejecting Trump and saying they would vote for Clinton. Thus not all of the Republican senators are sure to support Trump's initiatives; his majority isn't bulletproof.
- Further, the tradition of filibuster in the Senate allows a member to prevent action on a bill (other than a budget) unless the filibuster is lifted through the invocation of "cloture" Cloture requires support from 3/5 of the senators voting (usually 60), with the very new exception of certain executive and judicial appointments (but not Supreme Court nominees), when a simple majority is sufficient. Thus the Republicans' small majority isn't enough to ensure smooth sailing in most cases.

For all these reasons, even though Republicans control both houses of Congress, I don't think Trump necessarily has a blank check. Hopefully circumstances in the Senate will push him toward moderation.

I felt during the campaign that, as opposed to Hillary Clinton, the range of possible actions and outcomes in a Trump administration was far too broad to be predicted. I'm still convinced that's the only thing we know for certain.

Majority Doesn't Rule

In "The Implications of the Election" last week, I talked about the shortcomings of the Electoral College. Now they have been made clear. As mentioned earlier, even though Hillary Clinton won the popular vote by about 0.5%, Donald Trump is projected to win in the Electoral College by a big margin, 306 to 232, when it votes officially next month. Thus his 47.3% of the popular vote (Clinton got 47.8%, and 4.9% voted for the candidates of so-called "third parties") translated into 57.9% of the Electoral votes.

This alchemy is attributable primarily to the fact that all of the states other than Maine and Nebraska allocate their electoral votes not in proportion to the candidates' popular votes in the state, but rather on a winner-take-all basis.

Clinton won a few big states by huge margins – like NY's 29 electoral votes by 58% to 37%, and the top prize, California with its 55 electoral votes, by 62% to 33%. But since all the electoral votes go to the person with the most popular votes, anything in excess of a simple majority is "wasted." In these two states combined, with 15.2 million votes cast, Clinton got 9.6 million, which was 2 million more than she needed to win. Those extra votes padded her popular vote total, but they could do nothing to help her win the presidency.

Trump, on the other hand, won a larger number of states – many of them small to mid-sized – and in six cases by less than 5%. But, as I said above, 51/49 produces the same outcome as 70/30. So even though Trump received fewer popular votes in total than Clinton, he used them much more efficiently (meaning his average margin of victory was smaller). He got 5.1 electoral votes per million popular votes, whereas Clinton got only 3.8. Of course that's basically undemocratic.

This process translates into outcomes that can deny the election to the candidate for whom more people voted. Last week's election was the fourth time that has happened in our nation's history, but also the second time in the last 16 years.

Here's what CBS reports one astute observer to have said about this arrangement in 2012:

> The phoney [sic] electoral college made a laughing stock out of our nation. The loser one!
>
> He lost the popular vote by a lot and won the election. We should have a revolution in this country!

That observer was Donald Trump, responding erroneously to Obama's 2012 reelection (Obama actually won the popular vote). For some odd reason, those tweets have now been taken down.

There have been unsuccessful efforts to change the process so that future presidents will be chosen on the basis of the national popular vote, including one as recently as 1969. Another is currently underway, but the road is long and arduous. I hope the situation will be revised . . . and that I live to see it.

But in the meantime, the vote in the Electoral College is the vote that counts. Thus candidates allocate their time, effort and resources to maximize those votes, rather than popular votes. Although I'd prefer a different system, it's the one we've got, and complaints about the legitimacy of a victory that isn't accompanied by a popular vote majority don't resonate with me.

As an aside, a very similar phenomenon impacted the battle for this year's Republican nomination. A few years ago, the party changed the system to winner-take-all in the early primary races. The purpose was to quickly winnow the field to focus the contest on candidates capable of garnering significant support.

Thus when Trump was up against 16 other candidates in the primaries, he distinguished himself from the others and was able to win 100% of the delegates at stake with vote percentages generally in the twenties. This enabled him to take a commanding lead before the Republican establishment was able to respond to his insurgent candidacy. Here too, winner-take-all voting may come under examination.

The Outlook for the Parties Revisited

In "The Implications of the Election," I mentioned the uncertain future of the Republican party – with a schism possible between Trump's followers and the unsupportive party establishment. (Now that Trump has won, it's possible all will be forgiven.)

Now I want to point out the possibility of a schism among Democrats.

- There was a clear divide during the primaries between Clinton's centrist supporters and Bernie Sanders's considerably more liberal backers.
- Many of the latter became disgruntled when Clinton received the nomination, and some are likely to have abstained from voting in the general election.
- It's possible some will attribute Clinton's loss to an easily-beatable Republican candidate to her less liberal agenda and membership in the party's old guard. This may cause the liberal faction to try to exert more effort next time to ensure that their kind of candidate is nominated.

Thus I think the 2016 presidential election – and Trump's catalyzing role in it – will have implications on both sides of our political process for years to come. These too, however, are unpredictable.

* * *

This is the last memo on politics for a while, I hope (as may you).

November 14, 2016

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Memo to: Oaktree Clients

From: Howard Marks

Re: Expert Opinion

In August, I mentioned that I had chosen the title "Political Reality" for my memo in part because of my liking for oxymorons. I classed that title with other internally contradictory statements, such as "jumbo shrimp" and "common sense." Now I'm going to discuss one more: "expert opinion."

This memo was inspired by a thought that popped into my head when the outcome of the election settled in. You may point out that at the end of my November 14 memo "Go Figure!," I said I wouldn't write any more about politics. True, but I didn't say I wouldn't *think* about politics. Anyway, this memo isn't about politics, it's about opinions.

Last spring I attended a dinner where one of Hillary Clinton's senior advisers was soliciting input, as she and her campaign were struggling to come up with an effective counter to Bernie Sanders's populist message. Most of those present expressed frustration on the subject, until an experienced, connected Democrat assured everyone, "Don't worry. She'll win. The math is irresistible." The Hillary supporters were relieved, and he turned out to be right: she won the nomination going away.

In late October, with the issue of Clinton's private email server and the FBI's new investigation further dogging her, that same seasoned Democrat was asked whether the election was in jeopardy. "Don't worry," he said. "She'll win. The math is irresistible." We all know the result.

The opinions of experts concerning the future are accorded great weight . . . but they're still just opinions. Experts may be right more often than the rest of us, but they're unlikely to be right all the time, or anything close to it. This year's election season gave us plenty of opportunities to see expert opinion in action. I'll start this memo by reflecting on them.

The Year Polls Stopped Working

Pollsters got off to a tough start last year with the June referendum concerning Britain's membership in the European Union. Right up to the end, both pollsters and bookmakers considered U.K. citizens 70% likely to vote to remain a member. But, in the end, "Leave" won by a few percent.

The reaction was shock. Voters on both sides of the issue were unprepared for the outcome. Within a day or two, the leaders of Britain's main political parties had stepped down. People began to seriously discuss what that outcome meant and how "Brexit" would be accomplished.

The explanations for the pollsters' error centered around Britain's lower level of experience with, and expertise in, polling. It couldn't happen in the U.S. In fact, in the 2008 and 2012 presidential elections, Nate Silver, the proprietor of website *FiveThirtyEight*, correctly predicted the outcome in all 50 states once and in 49 the other time.

In 2016, *FiveThirtyEight* estimated the odds of Hillary Clinton winning as slightly better than 50/50 as of the end of the Republican convention in July. Then it had her as an 8-to-1 favorite in August, when the Democrats concluded their convention and Donald Trump's perceived missteps peaked. And then it again said she was slightly ahead just before the first presidential debate on September 26. It never made her out to be an underdog. And on election day, it estimated that she was 71.4% likely to win.* Most other pollsters put her chances of winning at between 80% and 99%, and only one considered Trump the favorite.

In the end, of course, Trump won in the Electoral College by a final count of 304 to 227, despite losing the popular vote by almost 2.9 million votes, or about 2%. In particular, he won in a number of "swing states," such as Pennsylvania, Michigan and Wisconsin, where the polls had him well behind. So much for experts' forecasts.

Finally, rounding out the pollsters' failures in 2016, the reform referendum that Italy's Prime Minister Matteo Renzi bet his career on – which had been considered 3% behind – lost by 20%. The outcome wasn't a surprise, but the margin certainly was.

No one really knows why polling failed so miserably last year. Clearly there was a groundswell of populist, anti-establishment and anti-insider sentiment, but shouldn't it have been detected? In particular, Trump did much better than predicted (or much less badly) with a number of important groups, such as Hispanics and college-educated women.

For some reason, in 2016 pollsters in all three countries either failed to talk to a representative sample of voters, failed to elicit honest responses, or failed to accurately interpret the data. Thus their opinions may be accorded less weight in the future.

So Much for the Experts

I'm struck by how dramatically opinion can flip-flop:

- During the run-up to the election, Clinton's campaign organization and "ground game" were considered sophisticated, efficient and unstoppable, and Trump's were thought of as rag-tag, underfunded and uncoordinated. Now Trump's machine is described as having been highly effective, and Clinton's as having missed important signs and opportunities.

- Clinton's message was thought likely to carry a lot of weight with a broad swath of the electorate, while Trump's was viewed as appealing deeply to a few fervent but narrow fringe constituencies without enough voters for him to win. After the fact, Trump is described as having had "perfect pitch" and Clinton as having a "tin ear."

- In particular, now it's considered to have been a big mistake for Clinton to fail to address the concerns of white men and set out a solution for those who lost jobs and were omitted from economic progress. But during the campaign, no one pointed to this error.

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* It should be noted – to his credit – that Silver insisted repeatedly that Trump could win. In fact, he often reminded his followers that the Clinton landslide most people expected was no more likely than a modest Trump victory. Silver also entered Election Day citing a 10.5% probability that Trump would lose the popular vote but win the presidency. We can't say he predicted that outcome, but (a) he was more explicit about it than most and (b) he assigned a fairly material probability to an event that in the past has been quite rare (so it can't be said that he was just extrapolating).

- Finally, up until Election Day, most observers (including me) talked about the likelihood that the Republican Party would emerge from the election torn between its traditional faction, the Tea Party conservatives, and Trump's economically disgruntled, anti-establishment supporters. That may turn out to be the case, but now the Democratic Party is described as being at risk as well because of the schism between the Clinton-type moderates and the Sanders/Warren progressives.

Here's some of what I wrote in "Go Figure!," six days after the election:

> Think back to just before last week's election. What did we know?
>
> - The polls were almost unanimous in saying Hillary Clinton would win . . .
> - There was a near-universal belief that a Trump victory – as unlikely as it was – would be bad for the markets.
>
> So what happened? First Clinton didn't win. . . . And second, the U.S. stock market had its best week since 2014! . . . Thus two key observations can be made based on last week's developments:
>
> - First, no one really knows what events are going to transpire.
> - And second, no one knows what the market's reaction to those events will be.

One of the key conclusions we should draw from the surprises of 2016 is that the pundits often failed to understand people and their views. It's clear that people who work in the media hadn't understood many average Americans; people with college degrees hadn't understood those without them; and people living on the coasts and in metropolises hadn't understood the rest. Strong sentiments and beliefs swung a pivotal election in ways the experts absolutely failed to grasp and thought were virtually impossible.

Of course there are no "facts" regarding most future events, just opinions. Experts – especially people who are paid to be experts – often couch their statements as facts, but that doesn't mean they're sure to come true.

And the Media?

When I was young, a limited number of media outlets were the public's primary source of information. There were three TV networks and four local stations – no more room on the dial – and until 1987 they were subject to the FCC's Fairness Doctrine that required broadcasters to discuss controversial matters of public interest and air contrasting views. Edward R. Murrow, a TV news anchor, was one of America's most respected men, and I often make reference to the time he said, "Anyone who isn't confused doesn't really understand the situation." Walter Cronkite, Chet Huntley and David Brinkley were similarly trusted. Newspapers may have had Democratic or Republican leanings, but outside the editorial pages they largely avoided partisanship in covering events.

The subsequent proliferation of cable TV networks set off powerful competition for viewers. A few chose to be full-time purveyors of news, along with some talk-radio stations. Rush Limbaugh, Roger Ailes and Rupert Murdoch realized that a big following – and big money – could result from highly partisan, even inflammatory, broadcasting. Radio "shock jocks" like Don Imus and Howard Stern chipped away at standards for language and demeanor, and news and talk shows emulated them. So now we have outspoken, boisterous speech, along with highly partisan messaging.

These days the news media shows little resemblance to what it was 30, 40 or 50 years ago. **Many outlets are highly biased to one side or the other and make it possible to read, watch and listen all day and never be exposed to all aspects of the issues.** Thus most people find something to complain about in the media coverage of the 2016 presidential election.

Today's media personalities rarely express the confusion Murrow did. Rather, they tend to state forecasts as certainties. When do you hear a TV commentator say "I think" or "it seems to me"?

In fact, they often remind me of the description of economists I heard in the 1970s: "portfolio managers who never mark to market." That is, they find it easy to overlook the times when they're wrong. In August or September of 2015, when Donald Trump was beginning to achieve success in his pursuit of the Republican nomination, a *New York Times* columnist flatly stated that because Trump couldn't stand the prospect of losing, he would drop out of the race before the primaries began in January. We didn't see that happen . . . or any further mention of his assertion.

What to Do About the Media

Given the nature of the candidates for the presidency, the starkness of the choice, and the recent trends in media coverage, I spent a great deal of time last year following political developments via websites, newspapers and television coverage. Most people I know did, and you may have as well. For many it became a preoccupation, even a mania.

My son Andrew has helped me dope out the media effects:

- Following events makes people feel they're actively involved in them and well informed.
- People think and act with more confidence when they consider themselves informed.
- But the media pundits often are no more insightful than the rest of us.
- And anyway, people tend to follow media outlets that confirm their beliefs rather than challenge them.
- Thus following the media experts, while entertaining, can be a waste of time intellectually.

For these reasons, I greatly enjoyed an article that appeared in the *Observer* on November 16, a week after the election. It was entitled "Want to Really Make America Great Again? Stop Reading the News." Ryan Holiday, its author, talked about what it's like to be caught up in the news cycle.

For a number of reasons, there has arisen in the media:

> . . . a system that needs more and more eyeballs for longer periods of time while gutting high-quality, reliable sources of information. We have more "news" but less original reporting than ever before, an order of magnitude more in the way of opinion and analysis, but as [author and academic] Tom Nichols has pointed out, somehow less expertise.
>
> Chuck Klosterman [a writer on American culture] once remarked at how strange it was to walk through the front offices of a football team and find that everyone there was watching ESPN. Didn't they have better information than the average viewer or

> reporter? Turns out, no – they're addicted to the same media we are and subject to the same groupthink. . . .
>
> Twitter isn't designed to help you get in and out with the best information as quickly as possible – it's supposed to suck you into either a contentious world of argument and debate or an echo chamber that reassures you everyone thinks like you do. . . .
>
> We're "participating" in the ecosystem because it's addicting and because we're curious.

So author Holiday came up with a useful prescription in response:

> It's not that I am going underground or completely disconnecting from current events. It's that I have decided I am no longer going to watch them develop in real time. I'm going to watch the Saints play every Sunday, [but] I'm not going to fool myself into thinking that tuning into "Sports Center" on Tuesday will help.

A lot of people's lives would be more tranquil and more productive if they accepted that what the media says about an upcoming event – and whether you watch or not – won't have any impact on the outcome.

<u>What Do the Experts Know?</u>

One of the reasons I crafted this memo this way is so I would have a chance to return to a subject I introduced in 2015: the *New York Post*'s "NFL Bettor's Guide." Each week during football season, the *Post*'s eleven experts advise its readers as to which teams to bet on. Here's how the experts did over the full 17-week season, covering 256 games:

- The best picker was right 55.1% of the time.
- The worst picker was right 48.8% of the time.
- On average the pickers were right 51.6% of the time.

The experts further help readers by specifying up to three "best bets" each week. Here's how they did on their strongest picks:

- The best picker was right 62.7% of the time.
- The worst picker was right 43.1% of the time.
- On average the pickers were right 54.0% of the time.

The available observations from this data are as follows:

- The way the overall results are distributed around 50/50 suggests the experts' process is little more than a coin toss.
- On average the experts were right just 2.4% more often on their "best bets" than on all their picks.
- Two of the experts did worse on their "best bets" than on their other picks.

- Eight of the eleven pickers were right more than half the time. But since it costs about 5% per week on average to bet with the bookies, **virtually none of the eleven experts' overall picks added value after fees (sound familiar?). Even the average of the experts' "best bets" wouldn't have produced a positive return after fees.**

Two additional observations:

- In week 16, all eleven of the experts predicted the favored New York Giants would beat the Philadelphia Eagles, and five of the eleven thought the underdog New York Jets would beat the New England Patriots (in both cases, after adjusting the scores for the "point spread" that the bookies impose to equalize the two teams' chances of winning). When the games were played, the favored Giants lost by five points (meaning they did even worse after the 2½-point spread was subtracted from their score), and the Jets (who were expected to lose by 16½ points) lost by 38 instead. In other words, (a) the experts may have been heavily biased in favor of the New York teams and (b) they were wrong 73% of the time on these two games.

- Bettors also have the option to bet on the "over/under" in a game – that is, whether the two teams' combined score will exceed or fall short of a threshold set by the bookies. It's just another way for bettors to get "action." The results show the experts were right in 128 games (52% of the time) and wrong in 123 (there were five ties). Again no value added, especially after fees.

If economists won't publish their performance data, the *Post* at least performs a service by showing how its football experts did. The bottom line is that their opinions are of little help, and the related coverage omits all discussion of their lack of predictive value.

The Importance of the Macro

Interest in "macro" has amped up meaningfully over the last dozen years or so. I think it largely started with the increased activism on the part of the Greenspan Fed, and investors' heightened interest in it. Today many analysts seem preoccupied with central bank behavior, government actions, trends in interest rates and currencies, and the movement of markets, as opposed to the fortunes of individual companies.

These things are almost all we hear about. And most people think knowledge regarding the outlook for them holds the key to investment success. Thus I want to make this a major topic here.

Since I speak a lot to clients, prospects, CFA societies and student groups, I get a lot of chances to hear what's on people's minds. And usually they focus on a relatively small number of questions. Over the last few years, the ones I've gotten most often have been these:

- What month will the Fed raise interest rates?
- What could go wrong in the economy or the market?
- What inning are we in?
- And in each country I visit, how's the outlook for that country?

When will the Fed raise interest rates? – On May 22, 2013, in testimony to Congress, then Fed Chairman Ben Bernanke surprised the world by saying, "If we see continued improvement, and we have confidence that that is going to be sustained, in the next few meetings we could take a step down in our pace of purchases [of bonds]. . . ." By indicating the Fed could "taper" its bond buying – the quantitative easing that was an important part of its stimulus program – Bernanke was foreshadowing that interest rates, which had been suppressed for years, would begin to rise.

Ever since then, people have been preoccupied with when interest rate increases would take place, and that's the question I've been asked most often. My response has been consistent: **How would I know, and why do you care?**

First, how would I know? I always point out that I'm not an economist or Fed watcher. And I don't think economists or Fed watchers know the answer, either. No one consistently knows the timing of these things in advance, in particular because the Fed itself probably doesn't know.

But more importantly, why would anyone care? If I say December, I ask them, what actions would you take? And if I changed that to March, would you do something different? The idea that you would do something different with a March expectation rather than a December expectation ignores the likelihood that the expectation of a March rate rise would begin to be reflected in asset prices well before March. That means the likely date of a rate rise is not a very useful piece of information.

What could go wrong? – For years it has felt to most people that we've been in a Goldilocks environment: neither too hot nor too cold. The economy hasn't grown slowly enough to cause recession or deflation, or fast enough to bring on hyperinflation and the need for restrictive action. The markets have been strong enough to bode well, but not so strong as to suggest a bubble. Ditto for investor psychology.

Most people don't want to tempt fate by saying things will go well forever, and in fact they know they won't. It's just that they can't decide what it is that will go wrong. The truth is that while I can enumerate them, the obvious candidates (changes in oil prices, interest rates, exchange rates, etc.) are likely to already be anticipated and largely priced in. It's the surprises no one can anticipate that would move markets most if they were to happen. But (a) most people can't imagine them and (b) most of the time they don't happen. **That's why they're called surprises.**

So I can guess at "improbable disasters" like acts of war, disinflation or a sudden seizing up of the economy, but they're unlikely to happen, and I don't know much more about them than anyone else. The greatest single influence of the last three years was doubtless the 75% decline in the price of oil from June 2014 to February 2016. But who predicted it?

In my memo "It's All Good" (July 2007), on the doorstep of the financial crisis, I insisted that the good times couldn't roll on forever. But I didn't know it was sub-prime mortgages that would be the catalyst for a turn for the worst, and when I listed my candidates, I ended with "the things I haven't thought of." That's still about the best I can do . . . or most others, it seems.

What inning are we in? – Perhaps no one can say just what it is that will ring the bell on today's positive trends, but people still want to know how advanced we are in the process, and thus when it will come to an end. People began to ask me what inning we're in during the financial crisis of 2008, and they've continued ever since.

First of all – admittedly I'm being picky here – people rarely specify which game they're asking about. Is it the economic recovery, the credit expansion, the string of low-default years, the upswing in investor psychology, or the stock market rise? Certainly the answer could be different for each.

But, more importantly, the question assumes we know how long each game will go on. A standard baseball game consists of nine innings, so "second inning," "sixth" or "ninth" has a clear meaning. But with the things we're wondering about here, we never know how long the game will run.

So rather than "what inning," I'd suggest investors ask whether things are or are not in an extended state. Is psychology depressed, average or euphoric? Is the capital market shut tight, normal or unthinkingly generous? These are questions that can be answered in a helpful way, not how close the game is to being over. No one knows the answer to the latter.

What's the outlook for country xyz? – The bottom line for me here is that people tend to confuse general intelligence, good investment records, expertise in specific areas, and all-around insight. Thus I'll reiterate that I'm no economist (and even if I were, my chances of being right would be limited). And then I'll add that being experienced as an investor and even hopefully intelligent says nothing about being able to divine a specific country's macro potential.

After I spend a day or two in a country, people often ask for my conclusions. But in the course of my visits, I generally (a) visit only big cities, (b) meet only with financial types, and (c) spend more time answering questions than gathering information. In fact, on one recent visit I responded to the usual question by telling my audience that I hoped each member knew more about their country than I did. I sometimes gain visceral impressions of the countries I visit, but they're usually data-lite and likely to come true only in the longest run, if at all.

Implications of the Election

Of course, the U.S. presidential election was the biggest story of 2016, and it brought me endless questions. Who would win? I'd read the same polls as everyone else, lived on the coasts, and reached the same conclusions. I could bring no unique insight on the basis of which to question the likelihood of a Clinton victory.

How would the two candidates differ as president? It didn't take any brilliance to conclude that a Clinton administration would be quite predictable and operate within rather narrow boundaries, while anything was possible from a Trump presidency – in some cases better than a Clinton one, but also with considerable potential for worse.

I was in Australia on Election Day and just after, and questions about the implications started immediately. In fact, they're what inspired me to write "Go Figure!" over the following weekend in Seoul. In it, I described the following questions as being open:

- How much of what Trump said while campaigning did he mean?
- How much of what he actually meant will he try to implement?
- And how much of what he tries to implement will he be able to effect?

We still don't have answers. As for the markets, it's clear Trump intends to be a very pro-business president. But what actions he'll take and whether they'll succeed is very much up in the air.

Of course, only nine weeks have elapsed since the election. Any expert who tells you what's in store from the Trump administration – or from Britain's departure from the EU; Italy without reform and Renzi; the Indian economy with 85% of its currency cancelled (the highest-denomination notes, 500 and 1000 rupees, were declared no longer legal tender in order to rein in corruption and the underground economy); or the coming elections in France and Germany – is talking through his hat.

My Opinion of Opinions

Since I've discussed these things at great length over the years, I'll try here to sum up succinctly:

- There are no facts about the future, just opinions. Anyone who asserts with conviction what he thinks will happen in the macro future is overstating his foresight, whether out of ignorance, hubris or dishonesty.

- Developments in economies, interest rates, currencies and markets aren't the result of scientific processes. The involvement in them of people – with their emotions, foibles and biases – renders them highly unpredictable. As physicist Richard Feynman put it, "Imagine how much harder physics would be if electrons had feelings!"

- It's one thing to have opinions on these subjects, but something very different to be confident they're right (and act on them).

- Taking bold action based on forecasts of things that are uncertain isn't just misguided; it's dangerous. As Mark Twain said, "It ain't what you don't know that gets you into trouble. It's what you know for certain that just ain't true."

- Everyone at Oaktree has opinions on the macro. And when we see extremes in markets and, especially, capital market behavior, we're apt to take strong action. But we're highly aware of what we don't know, and when conditions are moderate or indistinct, we don't bet heavily.

I'll end this section by sharing my latest epiphany on the macro. I realized recently that in my early decades in the investment business, change came so slowly that people tended to think of the environment as a fixed context in which cycles played out regularly and dependably. But starting about twenty years ago – keyed primarily by the acceleration in technological innovation – things began to change so rapidly that the fixed-backdrop view may no longer be applicable.

Now forces like technological developments, disruption, demographic change, political instability and media trends give rise to an ever-changing environment, as well as to cycles that no longer necessarily resemble those of the past. That makes the job of those who dare to predict the macro more challenging than ever.

What about Facts?

While I take a dim view of forecasts, and especially of opinions presented as facts, I do believe there are such things as facts. Unfortunately, however, the concept of "facts" is among the casualties of the increasingly partisan environment. **Recently we have seen both the elevation in status of "non-facts," as well as the tearing down of "real facts."**

"Fake news" emerged as a significant issue in 2016. Some people believe it influenced the election. Ease of access to social media makes it quite simple to create and disseminate statements that others will believe, even if they're total fabrications. The pizzeria fronting for a child-abuse ring led by Hillary Clinton is just one of 2016's wilder examples. I expect to see continuing discussion of the proper role of social media in taking down untrue posts, and of the conflict between defending freedom of expression and preventing the publication of falsehoods.

At the same time, I'm concerned about the disappearance of real facts. Nowadays it seems almost anything can be characterized as questionable. There's broad agreement among scientists that humans play a significant role in climate change – as there is among sitting world leaders – and yet we hear this idea dismissed as "a matter of opinion." The other day I heard a former U.S. Senator who now leads a policy think tank describe as "fake news" a Congressional Budget Office report with which his organization takes issue. If the non-partisan CBO isn't accepted as objective and truthful, who will be?

In a time of raging partisanship, disrespect for experts, and drastically debased standards for discourse, is there such a thing as a fact? Can there be no distinction between opinion, fact and fake fact? Can there be a figure everyone trusts, another Edward R. Murrow? Can any statement be safe from disparagement even though it's not 100% measurable and provable? Is history subject to unlimited revision if there are no video images? What will our grandchildren be taught is the meaning of the word "true"? What authorities will they trust? We certainly live in interesting times.

Macro Investor Performance

The acid test of an investment strategy is whether it produces good results. So here we are: first, "everyone knows" macro is a key determinant of investor performance these days, and second, there have been a lot of significant macro developments of late, providing opportunities for those with foresight to apply their predictive powers. Thus the ingredients have been in place for significant gains on the part of macro-oriented investors.

Let's take a look at the results for two Hedge Fund Research macro fund indices and compare them against the HFR index of all hedge funds:

	Periods ended November 30, 2016		
Annualized Net Returns	1 year	3 years	5 years
HFRI Macro (Total) Index	(1.17%)	1.64%	0.74%
HFRI Macro: Discretionary Thematic Index*	(1.96)	(0.47)	0.35
HFRI Fund Weighted Composite Index	3.37	2.46	4.23

* Macro funds run by individuals, not algorithms

While the average hedge fund's return has been puny, I think it's fair to say the average macro fund's return has been seriously deficient. **In fact, the average macro fund's net return may not have been statistically different from zero**. Thus, based on the indices, it's hard to say managers paid to profit from macro developments have done so.

The Last Word

To close, I'll weave together a few recent inputs:

First, I had dinner with Warren Buffett about a year ago, and he pointed out that **for a piece of information to be worth pursuing, it should be important, and it should be knowable**. These days, investors are clamoring more than ever for insights regarding the macro future, because it's important: it moves markets. But there's a hitch: Warren and I both consider these things largely unknowable. He rarely bases his investment actions on them, and neither does Oaktree.

Second, I want to include a final paragraph from the *Observer* article about the media that I mentioned earlier. I think it's golden:

> **"If you wish to improve," Epictetus [first-century Greek philosopher] once said, "be content to appear clueless or stupid in extraneous matters." One of the most powerful things we can do as a human being in our hyperconnected, 24/7 media world is say: "I don't know." Or more provocatively, "I don't care."** Not about everything, of course – just *most things*. Because most things don't matter, and most news stories aren't worth tracking. (Emphasis added)

Finally, I want to describe a great phone call I received this past spring, from a sell-side economist I worked with in the early '70s and have stayed in touch with since. "You've changed my life," he said. "I've stopped making forecasts. I study data and report on my inferences. But I no longer express opinions about the future." Mission accomplished.

January 10, 2017

<u>Bonus section</u>: I've been collecting (and recycling) quotations for almost forty years, more of them concerning forecasts than anything else. Here are five of the very best. **Together they say virtually everything that has to be said on the subject:**

> We have two classes of forecasters: Those who don't know – and those who don't know they don't know.
>
> – John Kenneth Galbraith

> No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future.
>
> – Ian Wilson (former GE executive)

Forecasts create the mirage that the future is knowable.

– Peter Bernstein

Forecasts usually tell us more of the forecaster than of the future.

– Warren Buffett

I never think of the future – it comes soon enough.

– Albert Einstein

Legal Information and Disclosures

Memo to: Oaktree Clients

From: Howard Marks

Re: Lines in the Sand

In my 2016 year-end review, which went only to clients, I included a discussion of the use of subscription lines by closed-end funds in areas such as private equity, real estate, distressed debt and private credit. It's my impression that their use has become fairly pervasive in recent years, and in response to clients' requests and market trends, Oaktree has utilized subscription lines in some of its newer funds.

That year-end note prompted some interesting and spirited discussion of lines and their merit and effect. Thus I decided to write this memo on the topic for general circulation.

<u>How Do Subscription Lines Work?</u>

As I wrote in the year-end review, subscription lines are bank loans extended to funds that enable them to use borrowed money, rather than LP capital, to make early investments or pay fees and expenses. While there is no universal description, I believe it's safe to say in general that subscription lines:

- are limited as a percentage of the LPs' capital commitments. (Commitments from the most creditworthy LPs earn a 90% advance rate, and commitments from lesser credits earn lower advance rates or, in some cases, zero),
- are secured by the LPs' capital commitments, and
- generally must be repaid in the early or middle part of the fund's life (unless extended), although terms are beginning to lengthen.

The key element is that a subscription line can substitute for LP capital, but it can't be used to allow the fund to invest more than its committed capital. That is, a $100 million fund with a subscription line might be able to buy $50 million of assets without calling LP capital, but it still can't invest more than $100 million in total (other than by recycling proceeds from liquidated investments). **The bottom line is that essentially all subscription line financing does is defer the calling of LP capital.**

So the starting point for this discussion is the fact that these lines lever LP capital but do not lever funds in the sense of allowing funds to invest more than their committed capital. Fund-level debt that allows funds to invest more than their committed capital is different from subscription lines and not my subject here.

What Are the Effects?

Since a subscription line doesn't lever a fund, its use doesn't increase the total dollar profits that the fund will earn from investments over its lifetime (assuming the GP makes the same investments that it would have made if the fund didn't have a line).

Also, the use of a subscription line – obviously – doesn't alter the fund's committed or invested capital. **Thus, assuming all LP capital eventually is drawn, the fund's ratio of distributions to LP capital – either the multiple of committed capital (MOCC) or the multiple of invested capital (MOC) – isn't improved by the use of a line.**

So much for what isn't changed. The question, then, is "what is?" First the positives:

- The original purpose of subscription lines was (a) to enable GPs to make investments and pay fund fees and expenses without frequent capital calls and (b) to prevent opportunistic funds that don't sit on large amounts of cash from missing out on attractive investments requiring quick funding. More recently, however, their use has grown for the additional reasons discussed below.

- With calls for LP capital postponed**, the reported Internal Rate of Return or IRR in the early years – the dollar-weighted return on LP capital – will increase substantially** (assuming the early profits exceed the interest and expenses on the line).

- **The use of borrowed money can reduce or even eliminate the deleterious impact on early returns of the so-called "J-curve."** The J-curve results from (a) the fact that in a fund's early years, management fees are usually charged on total committed capital, while a relatively small percentage of the capital has been put to work, and (b) the tendency of private investments to take a while to show results.

- Over the course of a fund's life, LP capital will typically be called for investments or to repay the borrowings under the subscription line. This will cause the ratio of subscription line capital employed to LP capital to decline. As a result, the fund's IRR will retreat from its elevated early level and move down toward what it would have been if the fund hadn't employed a subscription line. **However, all other things being equal, the fund's lifetime IRR will remain higher than it otherwise would have been, since the impact of using the line will taper off but not reverse.**

- Finally, any committed capital that hasn't been called because of borrowing under the line will remain in the hands of the LPs. **Thus any return the LPs earn on the uncalled capital in excess of their share of the fund's subscription line costs will be additive to their results.**

What about the negatives?

- **If a fund finances investments by borrowing under a subscription line, interest and expenses will be paid that wouldn't have been paid if LP capital had been called instead.** The payment of these costs, even with interest rates below LIBOR+2%, is a permanent net negative for the fund: since the fund isn't becoming levered, it won't be offset by an increase in dollar profits (see above). Thus it eats into the fund's dollar lifetime gains as well as its multiple of capital.

Some LPs may actually want to have their capital called and earn their preferred return. That will jibe with their expectations and preserve the historic hurdle for incentive fees. The preferred return that must be earned before the GP receives incentive fees is calculated based on how much LP capital has been called and for how long it has remained outstanding. Thus the use of a subscription line in lieu of LP capital shrinks the dollar preferred return hurdle. **Lowering the hurdle can increase the GP's probability of collecting incentive fees and cause the payment of incentive fees to the GP to begin sooner,** although it will have no effect on the amount of incentive fees ultimately paid by a fund that would easily have cleared the percentage hurdle rate if it hadn't used a line. (At the same time, however, the interest and expenses paid on the line will reduce the fund's lifetime net dollar gains, and thus the eventual amount of incentive fees received by the GP. The interaction of these effects can be complex.)

- **Less disciplined or less diligent GPs may be induced to lower the standards to which they subject investments** because (a) their effective cost of capital seems so low and/or (b) they perceive an increased likelihood that the reported IRR will exceed the preferred return hurdle and thus a greater potential to earn incentive fees.

- Some LPs seek to avoid so-called Unrelated Business Taxable Income ("UBTI"). Without getting into further details, **suffice it to say the use of subscription lines increases the risk of UBTI to these LPs.**

- Since each LP's commitment to the fund is an essential part of the bank's collateral, **the existence of a line could conceivably complicate the process of selling an LP interest in a secondary transaction**, in particular if the would-be buyer is less creditworthy.

- As the use of subscription lines increases, many banks are requiring greater and more intrusive information on the financial wherewithal of fund LPs to ensure the sufficiency of collateral. Some LPs are now starting to push back on providing this information, while others are expressly demanding to be excluded from borrowings, which can create an awkward dynamic among the LPs and between the LPs and GP.

Given the existence of so many pros and cons, what factors have caused the use of subscription lines to become widespread? I believe they're these:

For LPs:

- the desire for high reported IRRs,
- better cash management, including fewer drawdowns, and
- the potential to use their capital more efficiently (i.e., to use undrawn capital to make investments that may add to overall profits)

For GPs:

- the expectation that higher IRRs will enhance their reputations and enable them to raise more money,
- the potential to lower the hurdle that must be cleared before incentive fees are received,
- the ability to enhance reported results in a low-return world or mask otherwise-low investment returns, and
- defensively, a way to be competitive with other GPs who raise IRRs through the use of lines

Impact on Fund Performance Metrics

The most important question in assessing fund performance is clear: **Did the GP do a good job?** It's a simple question, but answering it is anything but. **In particular, if a fund that used a subscription line shows a high IRR, does that confirm that the GP did a good job?**

Since a fund's total dollar profits and multiple of capital aren't improved by the use of a subscription line, the increase in IRR, while pleasant, might be thought of as illusory. Remember, as I wrote in a 2006 memo with the same title, **you can't eat IRR**.

My basic point in that memo was that what really matters is how much money an LP makes as a result of having committed to a fund. It's that simple.

But the deeper message was that, while valuable, neither IRR nor MOCC nor MOC – nor any other single metric – is sufficient to tell us whether the GP did a good job. There are many elements that must be taken into account, and if you hold all the others equal, one metric might be sufficient to answer the question. But the others rarely are equal. For example:

- **A high IRR certainly is desirable.** But that's what a fund can show if the GP makes only one investment, with a small fraction of the fund's committed capital, and that investment produces a substantial profit. For example, if a $100 million fund invests $1 million in something and sells it a month later for $2 million, that doubling will annualize to an IRR of roughly 400,000%. And if that's the only investment the GP makes, that'll be the fund's IRR, too. But it certainly doesn't mean the GP did a good job – I doubt the LP who committed $10 million to the fund will be happy with $10.1 million back in the end.

  To understand what an IRR really says about fund performance, you have to know what percentage of the capital was called and how long the GP held onto it. In short, LPs want to see their committed capital become fully invested and remain invested at solid rates of return for a long time. That's the formula for a big gain. A high return earned on a small amount of capital for a brief period doesn't help in that regard. High annualized IRRs on investments of less than a year can be especially misleading.

- **A big multiple of invested capital is good, too.** But it also may be of limited significance. Let's say the GP of that $100 million fund invests $10 million, keeps it invested for the fund's entire ten-year life, and earns an annual return of 15% on that investment. That will result in proceeds of $40 million and thus an MOC of 4x. That's great for the LPs . . . as far as it goes. But if that's the only investment the GP makes, the LPs collectively will earn profits of only $30 million, certainly not what they had in mind when they committed $100 million to the fund. **So, again, to know if the GP did a good job, you have to know what percentage of the committed capital was invested and how long the investment was outstanding. You have to know what the GP did with the entire commitment, not just the part that was invested.**

- **Finally, a big multiple of committed capital sounds almost perfect. But it, too, isn't sufficient.** Let's say all of the fund's $100 million of committed capital is invested, and $300 million comes back to LPs, for an MOCC of 3x. That's good, isn't it? That depends on how long the GP kept that $100 million. If it took six years to turn $100 million into $300 million, the IRR on the fund is 20%. But if it took ten years to generate the same proceeds and MOCC, the IRR is just 11.6%. **So it's not enough to know how much capital was invested and how much was returned. We have to know how long the process took.**

The answer is simple. In order to be able to assess fund performance, we have to know:

- how much capital was committed,
- how much capital was invested,
- how long it was kept invested, and
- how much was returned to LPs.

IRR, MOCC and MOC are all significant indicators, but none of them takes all four of those parameters into consideration. Thus no single metric is sufficient to tell us how good a job a GP did. We have to consider multiple metrics, and sometimes they will give conflicting answers. Fund A may look better on one of them and Fund B on another. So this is really just one more way in which investing isn't subject to easy answers. Performance assessment requires consulting a variety of performance metrics; considering other factors as well, some of which are subjective (like how risky the portfolio was); and making judgments regarding the results.

One fund with a higher IRR didn't necessarily outperform another. And, provocatively, a fund that used a subscription line and came in with a high IRR may not have done as good a job – or made its LPs as much money – as one that didn't use a line (or used a line less extensively) and reported a lower IRR.

Let's take that to its logical extreme. What if the typical race to the bottom happens at the banks, making financing available on ever-easier terms? What if we reach a point where GPs are able to obtain lines equal in size to the vast majority of their LPs' commitments and keep the borrowings outstanding for most of the funds' life? In that case, there will be little need for a GP to draw LP capital, and even low returns on investments could give rise to ultra-high IRRs at the fund level. **The bottom line on all this is that the use of subscription lines sheds considerable doubt on the significance of IRR. And when IRR becomes suspect, anyone wanting to evaluate fund results has no choice but to put greater emphasis on the multiple of capital.**

Bigger Questions

All the above discussion is essentially mechanical, regarding matters of arithmetic. But there are other questions surrounding subscription lines that involve investment risk, and some that have bigger consequences . . . even potentially systemic.

Investments are invariably viewed as safe when it is assumed that the things that should happen will happen. But I always hasten to point out that "should" isn't the same as "will."

Let's consider the process that's supposed to apply with subscription line borrowings:

- The GP organizes a fund and arranges for a subscription line.
- LPs commit capital.
- The LPs put in an actual or virtual lock-box the funds they'll need when capital is called.
- The GP uses borrowings under the subscription line to pay for investments, in lieu of calling LP capital.
- When the subscription line reaches its end, LP capital is called and the line is repaid.

That's what's supposed to happen. But there are ways in which actual events can deviate from that idealized progression. Most of these would be the result of negative developments in the financial markets or the larger world.

- Since the use of subscription lines results in there being fewer but larger capital calls, the magnitude of potential defaults by LPs is increased, along with the potential consequences.

- Suppose the fund makes $5 million of investments against an LP's $10 million commitment – borrowing $5 million on the line – and there's a financial crisis (or the investments simply turn out to be big losers) and those investments decline in value to $2 million. **And suppose the line comes due, the fund calls $5 million from the LP with which to repay it, and the LP – perhaps receiving simultaneous capital calls from a number of similarly affected managers – concludes it's in its best interest (or its fiduciary duty) to NOT put up $5 million to secure investments now worth $2 million. Instead, it defaults on the capital call, depriving the fund of capital, potentially limiting the fund's ability to repay the line and/or make further investments, and thereby possibly harming the remaining LPs.** (Please note, however, that strategic defaults are an extreme hypothetical, since they would expose LPs to penalties, lawsuits and the forfeiture of their assets in the fund, in addition to the obvious reputational consequences.)

- Some funds (although none of Oaktree's) rely on subscription lines that are due on demand, rather than at the end of a stated term. What would be the effect if a large number of those lines were pulled simultaneously during a financial crisis? Or what if regulators required banks to call in their lines, even those that aren't callable or whose terms haven't expired?

- There's no question that the increasing use of subscription lines is altering the pattern of drawdowns and distributions. **Going years without seeing much capital called could convince an LP that calls have become less likely. Suppose that, in response, rather than set aside capital equal to its commitments, the LP puts it into other investments.** Although subscription lines don't result in <u>funds</u> becoming levered, this kind of behavior can

> result in <u>the LP</u> becoming levered (i.e., having total investments plus commitments that exceed its available capital). Now suppose a financial crisis brings large losses to fund investments in general. **If the LP has made excess commitments, it could (a) suffer levered losses and (b) be forced to liquidate marketable securities in a crisis to satisfy capital calls in connection with their commitments to closed-end funds.** Taken to a hopefully unrealistic extreme, could this cause LPs to become insolvent and banks to experience a wave of defaults on these lines?

Market meltdowns and financial crises can increase the probability that banks will recall lines and decrease the probability that all LPs will meet the calls. If an LP has taken advantage of subscription line financing to become more than 100% committed, it might be more likely to default on the calls.

If a fund has diversified commitment sources and just a couple of LPs default, the fund will probably manage just fine. But suppose many LPs default? In that circumstance it's easy to imagine a fund being forced to sell assets during a market downturn to pay off its line and/or lacking the capital it thought it would have with which to take advantage of market opportunities. Both outcomes could be very negative for funds and LPs alike.

The obligations of the LPs in a fund with a subscription line are interrelated; for example, one LP's default on its capital commitment requires the other LPs to contribute more (up to the amount of their commitment) to repay the subscription line. Could this mean that failures by some LPs would increase the likelihood of failures by others? In the extreme, if defaults on lines are widespread, could lines become a source of significant risk to banks?

In order to figure out the full impact of the use of subscription lines, one would have to know what LPs do with the uncalled capital during the period before it's drawn by the funds. It does seem, however, that subscription lines may be adding to risk at a variety of levels.

These hypothetical examples imagine financial crises, asset meltdowns and – in some cases – less-than-conservative behavior on the part of LPs. They're all unlikely. But are they impossible? **It's mostly during crises that weaknesses are exposed, things that are supposed to happen fail to do so, and unanticipated consequences and linkages manifest themselves.**

As I mentioned at the outset, some Oaktree funds have made use of subscription lines, in recognition of the advantages described above and because many of our LPs – almost all of which are sophisticated institutional investors capable of understanding how lines work and their pros and cons – have indicated that they want us to do so. However, I can report that the concerns discussed above have caused us to begin an internal process to develop guidelines intended to mitigate the risks of subscription lines while preserving their benefits.

The key to financial security – individual or societal – doesn't lie in counting on things to work in good times or on average. Rather, it consists of figuring out what can go wrong in bad times, and of only doing things that will prove survivable even if they materialize. Has anyone thought through all the implications of closed-end funds' increasing use of subscription lines? Are they all tolerable, for the individual parties and for the financial system? I haven't read much on this subject, but we should all be thinking about it. That's the reason I'm writing today.

April 18, 2017

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Memo to: Oaktree Clients

From: Howard Marks

Re: There They Go Again . . . Again

Some of the memos I'm happiest about having written came at times when bullish trends went too far, risk aversion disappeared and bubbles inflated. The first and best example is probably "bubble.com," which raised questions about Internet and e-commerce stocks on the first business day of 2000. As I tell it, after ten years without a single response, that one made my memo writing an overnight success.

Another was "The Race to the Bottom" (February 2007), which talked about the mindless shouldering of risk that takes place when investors are eager to put money to work. Both of those memos raised doubts about investment trends that soon turned out to have been big mistakes.

Those are only two of the many cautionary memos I've written over the years. In the last cycle, they started coming two years before "The Race to the Bottom" and included "There They Go Again" (the inspiration for this memo's title), "Hindsight First, Please," "Everyone Knows" and "It's All Good." When I wrote them, they appeared to be wrong for a while. It took time before they were shown to have been right, and just too early.

The memos that have raised yellow flags in the current up-cycle, starting with "How Quickly They Forget" in 2011 and including "On Uncertain Ground," "Ditto," and "The Race Is On," also clearly were early, but so far they're not right (and in fact, when you're early by six or more years, it's not clear you can ever be described as having been right). **Since I've written so many cautionary memos, you might conclude that I'm just a born worrier who eventually is made to be right by the operation of the cycle, as is inevitable given enough time. I absolutely cannot disprove that interpretation**. But my response would be that it's essential to take note when sentiment (and thus market behavior) crosses into too-bullish territory, even though we know rising trends may well roll on for some time, and thus that such warnings are often premature. **I think it's better to turn cautious too soon (and thus perhaps underperform for a while) rather than too late, after the downslide has begun, making it hard to trim risk, achieve exits and cut losses.**

Since I'm convinced "they" are at it again – engaging in willing risk-taking, funding risky deals and creating risky market conditions – it's time for yet another cautionary memo. **Too soon? I hope so**; we'd rather make money for our clients in the next year or two than see the kind of bust that gives rise to bargains. (We all want there to be bargains, but no one's eager to endure the price declines that create them.) Since we never know when risky behavior will bring on a market correction, I'm going to issue a warning today rather than wait until one is upon us.

I'm in the process of writing another book, going into great depth regarding one of the most important things discussed in my book *The Most Important Thing*: cycles, their causes, and what to do about them. It will be out next year, but this memo will give you a preview regarding one of the most important cyclical phenomena.

Before starting in, I want to apologize for the length of this memo, almost double the norm. First, the topic is wide-ranging – so much so that when I sat down to write, I found the task daunting. Second, my recent vacation gave me the luxury of time for writing. Believe it or not, I've cut what I could. I think what remains is essential.

Today's Investment Environment

Because I don't intend this to be a "macro memo," incorporating a thorough review of the economic and market environment, I'll merely reference what I think are the four most noteworthy components of current conditions:

- **The uncertainties are unusual in terms of number, scale and insolubility** in areas including secular economic growth; the impact of central banks; interest rates and inflation; political dysfunction; geopolitical trouble spots; and the long-term impact of technology.

- In the vast majority of asset classes, **prospective returns are just about the lowest they've ever been**.

- **Asset prices are high across the board**. Almost nothing can be bought below its intrinsic value, and there are few bargains. In general the best we can do is look for things that are less over-priced than others.

- **Pro-risk behavior is commonplace**, as the majority of investors embrace increased risk as the route to the returns they want or need.

Ditto

In January 2013, I wrote a memo entitled "Ditto." Its thrust was that (a) history tends to repeat, (b) thus my memos often return to the same topics and (c) if I've handled them well in the past, rather than re-invent the wheel, I might as well borrow from what I've written before. Ergo, "ditto."

Few topics are more susceptible to this treatment than the process through which (a) investment fundamentals fluctuate cyclically; (b) investors overreact to the fluctuations; (c) the level of risk aversion incorporated in investor behavior fluctuates between excessive and inadequate; and thus (d) market conditions swing from depressed to elevated and treacherous. Here's how I summed up on this topic in "There They Go Again" (May 2005):

> Given today's paucity of prospective return at the low-risk end of the spectrum and the solutions being ballyhooed at the high-risk end, many investors are moving capital to riskier (or at least less traditional) investments. But (a) they're making those riskier investments just when the prospective returns on those investments are the lowest they've ever been; (b) they're accepting return increments for stepping up in risk that are as slim as they've ever been; and (c) they're signing up today for things they turned down (or did less of) in the past, when the prospective returns were much higher. This may be exactly the wrong time to add to risk in pursuit of more

return. You want to take risk when others are fleeing from it, not when they're competing with you to do so.

Do you see any differences between then and now? Is there any need to redo this description? Not for me; I think "ditto" will suffice. I'll simply go on to borrow the conclusion from "The Race to the Bottom" (February 2007):

> **Today's financial market conditions are easily summed up: There's a global glut of liquidity, minimal interest in traditional investments, little apparent concern about risk, and skimpy prospective returns everywhere. Thus, as the price for accessing returns that are potentially adequate (but lower than those promised in the past), investors are readily accepting significant risk in the form of heightened leverage, untested derivatives and weak deal structures.** The current cycle isn't unusual in its form, only its extent. There's little mystery about the ultimate outcome, in my opinion, but at this point in the cycle it's the optimists who look best.

The Seeds for a Boom

My son Andrew worked extensively with me in preparing this memo. We particularly enjoyed making a list of the elements that typically form the foundation for a bull market, boom or bubble. We concluded that some or all of the following are necessary conditions. A few will give us a bull market. All of them together will deliver a boom or bubble:

- **A benign environment** – good results lull investors into complacency, as they get used to having their positive expectations rewarded. Gains in the recent past encourage the heated pursuit of further gains in the future (rather than suggest that past gains might have borrowed from future gains).
- **A grain of truth** – the story supporting a boom isn't created out of whole cloth; it generally coalesces around something real. The seed usually isn't imaginary, just eventually overblown.
- **Early success** – the gains enjoyed by the "wise man in the beginning" – the first to seize upon the grain of truth – tends to attract "the fool in the end" who jumps in too late.
- **More money than ideas** – when capital is in oversupply, it is inevitable that risk aversion dries up, gullibility expands, and investment standards are relaxed.
- **Willing suspension of disbelief** – the quest for gain overcomes prudence and deference to history. Everyone concludes "this time it's different." No story is too good to be true.
- **Rejection of valuation norms** – all we hear is, "the asset is so great: there's no price too high." Buying into a fad regardless of price is the absolute hallmark of a bubble.
- **The pursuit of the new** – old timers fare worst in a boom, with the gains going disproportionately to those who are untrammeled by knowledge of the past and thus able to buy into an entirely new future.
- **The virtuous circle** – no one can see any end to the potential of the underlying truth or how high it can push the prices of related assets. It's broadly accepted that trees can grow to the sky: "It can only go up. Nothing can stop it." Certainly no one can picture things taking a turn for the worse.

- **Fear of missing out** – when all the above becomes widespread, optimism prevails and no one can imagine a glitch. That causes most people to conclude that the greatest potential error lies in failing to participate in the current market darling.

Certainly many of the things listed above are in play today. Performance has been good – with minor exceptions, quickly rectified – since the beginning of 2009 (that's more than eight years). There's certainly more money around these days than high-return possibilities. "New ideas" are readily accepted, and some things are viewed as representing virtuous circles.

On the other hand, some of the usual ingredients are missing. **Most people (a) are conscious of the uncertainties listed above, (b) recognize that prospective returns are quite skimpy, and (c) accept that things are unlikely to go well forever.** That's all healthy.

But on the third hand, most people can't think of what might cause trouble anytime soon. But it's precisely when people can't see what it is that could make things turn down that risk is highest, since they tend not to price in risks they can't see. **With the negative catalyst so elusive and the return on cash at punitive levels, people worry more about being underinvested or bearing too little risk (and thus earning too low a return in good markets) than they do about losing money.**

This combination of elements presents today's investors with a highly challenging environment. The result is a world in which assets have appreciated significantly, risk aversion is low, and propositions are accepted that would be questioned if investors were more wary.

Most of what remains for the meat of this memo will consist of descriptions of things afoot in the markets today. They are intended – as usual with my memos – to be anecdotal and thought-provoking, not complete and scientific. Think about how many of the things listed above you see in the examples that follow.

U.S. Equities

The good news is that the U.S. economy is the envy of the world, with the highest growth rate among developed nations and a slowdown unlikely in the near term. The bad news is that this status generates demand for U.S. equities that has raised their prices to lofty levels.

- The S&P 500 is selling at 25 times trailing-twelve-month earnings, compared to a long-term median of 15.
- The Shiller Cyclically Adjusted PE Ratio stands at almost 30 versus a historic median of 16. This multiple was exceeded only in 1929 and 2000 – both clearly bubbles.
- While the "p" in p/e ratios is high today, the "e" has probably been inflated by cost cutting, stock buybacks, and merger and acquisition activity. Thus today's reported valuations, while high, may actually be understated relative to underlying profits.
- The "Buffett Yardstick" – total U.S. stock market capitalization as a percentage of GDP – is immune to company-level accounting issues (although it isn't perfect either). It hit a new all-time high last month of around 145, as opposed to a 1970-95 norm of about 60 and a 1995-2017 median of about 100.

- Finally, it can be argued that even the normal historic valuations aren't merited, since economic growth may be slower in the coming years than it was in the post-World War II period when those norms were established.

The thing that is clearest is that the low Fed-mandated short-term interest rates make high valuations seem reasonable. When yields are low on fixed income instruments, low earnings yields on equities (that is, low e/p ratios, which equate to high p/e ratios) seem justified. As Buffett said in February, "Measured against interest rates, stocks actually are on the cheap side compared to historic valuations."

But he went on to say, ". . . the risk always is that interest rates go up a lot, and that brings stocks down." **Are you happy counting on continued low interest rates for your investment security, especially at a time when the Fed has embarked upon a series of rate increases?** And if interest rates do remain low for several more years, isn't it likely to be as a result of a lack of vigor in the economy, which would likely cause earnings growth to be sluggish?

VIX

The value of an option contract is largely a function of the volatility of the asset under option. For example, the owner of a "call" has the right – but not the obligation – to buy something at a fixed "strike price." Thus he should hope the asset will be volatile: if its price rises a lot, he can buy at the strike price and sell at the new, higher price, locking in a profit. And what if it goes down a lot? No matter; he isn't obligated to buy.

Thus the expected volatility of the underlying asset is a key ingredient in determining the proper price for an option. For example, everything else being equal, the more volatile an asset is expected to be, the more the buyer of a call should be willing to pay for it (since he participates in the gains but not the losses) and the more the seller of a call should charge for it (since he is forgoing upside potential but retaining downside risk). This is reflected through option-pricing formulas such as the Black-Scholes Model.

The formulas can also be used backwards. Starting with the option price, you can figure out what level of volatility the buyers and sellers are anticipating. Thus, ever since 1990, the Chicago Board Options Exchange has published the CBOE Volatility Index, or "VIX," showing how volatile investors in options on the S&P 500 expect it to be over the next 30 days. The attention paid to the VIX has increased in recent years, and it has come to be called the "complacency index" or the "investor fear gauge." When the VIX is low, investors are pricing in stable, tranquil markets, and when it's high they're anticipating major ups and downs.

The bottom line is that last week's VIX was the lowest in its 27-year history – matching a level seen only once before. The index was last this low when Bill Clinton took office in 1993, at a time when there was peace in the world, faster economic growth and a much smaller deficit. Should people really be as complacent now as they were then?

What's the significance of the VIX, anyway? **Most importantly, it doesn't say what volatility will be, only what investors think volatility will be.** Thus it's primarily an indicator of investor sentiment. In "Expert Opinion" I quoted Warren Buffett as having said, "Forecasts usually tell us more of the forecaster than of the future." In a similar way, the VIX tells us more about people's mood today than it does about volatility tomorrow.

All we really know is that implied volatility expectations are low today. As with most things in investing, the VIX can be subject to multiple interpretations. As *Business Insider* wrote on July 18:

> While alarmists may view this [low level of VIX] as a negative — a signal that complacency has made traders vulnerable to an unforeseen shock — many investors simply see it as a byproduct of conditions ideal for stocks to continue edging higher.

I would add one last thing: people extrapolate. So when volatility **has been** low, they tend to assume it **will be** low and build that assumption into the prices for options and assets. **The two are not the same.**

Super-Stocks

Bull markets are often marked by the anointment of a single group of stocks as "the greatest," and the attractive legend surrounding this group is among the factors that support the bull move. When taken to the extreme – as it invariably is – this phenomenon satisfies some of the elements in a boom listed on page four, including:

- trust in a virtuous circle incapable of being interrupted;
- conviction that, given the companies' fundamental merit, there's no price too high for their stocks; and
- the willing suspension of disbelief that allows investors to extrapolate these positive views to infinity.

In the current iteration, these attributes are being applied to a small group of tech-based companies, which are typified by "the FAANGs": Facebook, Amazon, Apple, Netflix and Google (now renamed Alphabet). They all sport great business models and unchallenged leadership in their markets. Most importantly, they're viewed as having captured the future and thus as sure to be winners in the years to come.

True as far as it goes . . . just as it appeared to be true of the Nifty-Fifty in the 1960s, oil stocks in the '70s, disk drive companies in the '80s, and tech/media/telecom in the late '90s. But in each of those cases:

- the environment changed in unforeseen ways,
- it turned out that the newness of the business model had hidden its flaws,
- competition arose,
- excellence in the concept gave rise to weaknesses in execution, and/or
- it was shown that even great fundamentals can become overpriced and thus give way to massive losses.

The FAANGs are truly great companies, growing rapidly and trouncing the competition (where it exists). But some are doing so without much profitability, and for others profits are growing slower than revenues. Some of them doubtless will be the great companies of tomorrow. But will they all? Are they invincible, and is their success truly inevitable?

The prices investors are paying for these stocks generally represent 30 or more years of the companies' current earnings. There are clear reasons to be excited about their growth in the near term, but what about the durability of earnings over the long term, where much of the value in a high-multiple stock necessarily lies? Andrew points out that the iPhone is just ten years old, and twenty years ago the Internet wasn't in widespread use. That raises the question of whether investors in technology can really see the future, and thus how happy they should be paying prices that incorporate optimistic assumptions regarding long-term earnings power. Of course, this may just mean the best is yet to come for these fairly young companies.

Here's a passage from one company's 1997 letter to shareholders:

> We established long-term relationships with many important strategic partners, including America Online, Yahoo!, Excite, Netscape, GeoCities, AltaVista, @Home, and Prodigy.

How many of these "important strategic partners" still exist in a meaningful way today (leaving aside the question of whether they're important or strategic)? The answer is zero (unless you believe Yahoo! satisfies the criteria, in which case the answer is one). The source of the citation is Amazon's 1997 annual report, and the bottom line is that the future is unpredictable, and nothing and no company is immune to glitches.

The super-stocks that lead a bull market inevitably become priced for perfection. And in many cases the companies' perfection turns out eventually to be either illusory or ephemeral. Some of the "can't lose" companies of the Nifty-Fifty were ultimately crippled by massive changes in their markets, including Kodak, Polaroid, Xerox, Sears and Simplicity Pattern (do you see many people sewing their own clothes these days?). Not only did the perfection that investors had paid for evaporate, but even the successful companies' stock prices reverted to more-normal valuation multiples, resulting in sub-par equity returns.

The powerful multiple expansion that makes a small number of stocks the leaders in a bull market is often reversed in the correction that follows, saddling them with the biggest losses. But when the mood is positive and things are going well, the likelihood of such a development is easily overlooked.

Finally, a rationale often arises to the effect that, thanks to market technicals, investors' powerful buying of the leading stocks is sure to continue non-stop, meaning they can't help but remain the best performers. In the tech bubble of the late 1990's, for example, investors concluded that:

- stocks were doing so well that they would continue to attract capital,
- since tech companies and tech stocks were the best performers, they were sure to continue attracting a disproportionate share of the new buying,
- the superior performance of the tech stocks would cause more of them to be added to the stock indices,
- this would require index funds and closet indexers to direct a rising share of their buying to tech stocks,

- in order to keep up with the returns on the indices, benchmark-conscious active managers would have to respond by increasing their tech stock holdings, and,
- thus tech stocks couldn't fail to attract an ever-rising share of buying, and were sure to keep outperforming.

You can call this a virtuous circle or a perpetual motion machine. It's the kind of thing that fires investors' imaginations in a bull market. But the logic that says it will work forever always collapses, sometimes just under its own weight, as was the case in 2000.

Many of the most important considerations in investing are counterintuitive. One of those is the ability to understand that no market, niche or group is likely to outperform the others forever. Given human nature, "the best" will always come eventually to be overpriced, even for their stellar fundamentals. Thus even if the fundamentals hold up, the stocks' performance from those too-high prices will become ordinary. And if they turn out not really to have been the best – or if their business falters – the combination of fundamental decline and multiple contraction can be really painful.

I'm not saying the FAANGs aren't great, or that they'll suffer such a fate. Just that their elevated status today is a sign of the kind of investor optimism for which we must be on the lookout.

<u>Passive Investing/ETFs</u>

Fifty years ago, shortly after arriving at the University of Chicago for graduate school, I was taught that thanks to market efficiency, (a) assets are priced to provide fair risk-adjusted returns and (b) no one can consistently find the exceptions. In other words, "you can't beat the market." Our professors even advanced the idea of buying a little bit of each stock as a can't-fail, low-cost way to outperform the stock-pickers.

John Bogle put that suggestion into practice. Having founded Vanguard a year earlier, he launched the First Index Investment Trust in 1975, the first index fund to reach commercial scale. As a vehicle designed to emulate the S&P 500, it was later renamed the Vanguard 500 Index Fund.

The concept of indexation, or passive investing, grew gradually over the next four decades, until it accounted for 20% of equity mutual fund assets in 2014. Given the generally lagging performance of active managers over the last dozen or so years, as well as the creation of ETFs, or exchange-traded funds, which make transacting simpler, the shift from active to passive investing has accelerated. Today it's a powerful movement that has expanded to cover 37% of equity fund assets. In the last ten years, $1.4 trillion has flowed into index mutual funds and ETFs (and $1.2 trillion out of actively managed mutual funds).

Like all investment fashions, passive investing is being warmly embraced for its positives:

- Passive portfolios have outperformed active investing over the last decade or so.
- With passive investing you're guaranteed not to underperform the index.
- Finally, the much lower fees and expenses on passive vehicles are certain to constitute a permanent advantage relative to active management.

Does that mean passive investing, index funds and ETFs are a no-lose proposition? Certainly not:

- While passive investors protect against the risk of underperforming, they also surrender the possibility of outperforming.
- The recent underperformance on the part of active investors may well prove to be cyclical rather than permanent.
- As a product of the last several years, ETFs' promise of liquidity has yet to be tested in a major bear market, particularly in less-liquid fields like high yield bonds.

Here are a few more things worth thinking about:

Remember, the wisdom of passive investing stems from the belief that the efforts of active investors cause assets to be fairly priced – that's why there are no bargains to find. But what happens when the majority of equity investment comes to be managed passively? Then prices will be freer to diverge from "fair," and bargains (and over-pricings) should become more commonplace. This won't assure success for active managers, but certainly it will satisfy a necessary condition for their efforts to be effective.

One of my clients, the chief investment officer of a pension fund, told me the treasurer had proposed dumping all active managers and putting the whole fund into index funds and ETFs. My response was simple: ask him how much of the fund he's comfortable having in assets no one is analyzing.

As Steven Bregman of Horizon Kinetics puts it, "basket-based mechanistic investing" is blindly moving trillions of dollars. ETFs don't have fundamental analysts, and because they don't question valuations, they don't contribute to price discovery. **Not only is the number of active managers' analysts likely to decline if more money is shifted to passive investing, but people should also wonder about who's setting the rules that govern passive funds' portfolio construction.**

The low fees and expenses that make passive investments attractive mean their organizers have to emphasize scale. To earn higher fees than index funds and achieve profitable scale, ETF sponsors have been turning to "smarter," not-exactly-passive vehicles. Thus ETFs have been organized to meet (or create) demand for funds in specialized areas such as various stock categories (value or growth), stock characteristics (low volatility or high quality), types of companies, or geographies. There are passive ETFs for people who want growth, value, high quality, low volatility and momentum. Going to the extreme, investors now can choose from funds that invest passively in companies that have gender-diverse senior management, practice "biblically responsible investing," or focus on medical marijuana, solutions to obesity, serving millennials, and whiskey and spirits.

But what does "passive" mean when a vehicle's focus is so narrowly defined? **Each deviation from the broad indices introduces definitional issues and non-passive, discretionary decisions.** Passive funds that emphasize stocks reflecting specific factors are called "smart-beta funds," but who can say the people setting their selection rules are any smarter than the active managers who are so disrespected these days? Bregman calls this "semantic investing," meaning stocks are chosen on the basis of labels, not quantitative analysis. There are no absolute standards for which stocks represent many of the characteristics listed above.

Importantly, organizers wanting their "smart" products to reach commercial scale are likely to rely heavily on the largest-capitalization, most-liquid stocks. For example, having Apple in your ETF allows it to get really big. Thus Apple is included today in ETFs emphasizing tech, growth, value, momentum, large-caps, high quality, low volatility, dividends, and leverage.

Here's what Barron's had to say earlier this month:

> With cap-weighted indexes, index buyers have no discretion but to load up on stocks that are already overweight (and often pricey) and neglect those already underweight. That's the opposite of buy low, sell high.

The large positions occupied by the top recent performers – with their swollen market caps – mean that as ETFs attract capital, they have to buy large amounts of these stocks, further fueling their rise. **Thus, in the current up-cycle, over-weighted, liquid, large-cap stocks have benefitted from forced buying on the part of passive vehicles, which don't have the option to refrain from buying a stock just because its overpriced.**

Like the tech stocks in 2000, this seeming perpetual motion machine is unlikely to work forever. If funds ever flow out of equities and thus ETFs, what has been disproportionately bought will have to be disproportionately sold. **It's not clear where index funds and ETFs will find buyers for their over-weighted, highly appreciated holdings if they have to sell in a crunch. In this way, appreciation that was driven by passive buying is likely to eventually turn out to be rotational, not perpetual.**

Finally, the systemic risks to the stock market have to be considered. Bregman calls "the index universe a big, crowded momentum trade." A handful of stocks – the FAANGs and a few more – are responsible for a rising percentage of the S&P's gains, meaning the stock market's health may be overstated.

All the above factors raise questions about the likely effectiveness of passive vehicles – and especially smart-beta ETFs.

- Is Apple a safe stock or a stock that has performed well of late? Is anyone thinking about the difference?
- Are investors who invest in a number of passive vehicles described in different ways likely to achieve the diversification, liquidity and safety they expect?
- **And what should we think about the willingness of investors to turn over their capital to a process in which neither individual holdings nor portfolio construction is the subject of thoughtful analysis and decision-making, and in which buying takes place regardless of price?**

<u>Credit</u>

Corporate debt instruments are good candidates for spotting bull-market behavior given that (unlike equities, for example), we can readily determine their prospective returns. We know that, as described in "The Race to the Bottom," in overpopulated markets providers of credit compete to make loans and investments that embody low returns, weak structures and slender margins of safety.

Whatever the level of fundamental risk, sometimes the reward for bearing it is demonstrably inadequate, and sometimes it is highly excessive. **It's an over-simplification, but sometimes I think we could base our strategic decisions almost exclusively on the relationship between risk in the market and investors' willingness to bear it.**

It's very helpful to know – and a lot of my new book will be about – where we stand in that swing. In that regard, I'll remind you that "The Race to the Bottom" was prompted by a *Financial Times* article about U.K. banks' willingness to compete for mortgage business by increasing the multiple of annual income they would lend. Earlier this month, ironically, I read the following in another London newspaper, the *Daily Mail*:

> In a chilling echo of the sub-prime mortgage crisis of 2007, car finance firms packaged and sold £5.5 billion of risky loan debt to investors last year – twice as much as the year before.

Such eagerness to finance low-quality loans will always be a sign of elevated, over-financed, risk-oblivious credit markets. At the late-2008 trough of the financial crisis, high yield bonds and leveraged loans yielded almost 2,000 basis points more than comparable Treasurys, meaning anyone who bought and held couldn't really lose. Then, as investors recovered their equilibrium and bought, prices rose and the yield spread contracted. Now the spread is merely average relative to history – a few hundred basis points. The net yields on these securities are still highly likely to be well in excess of those on Treasurys, but any capital appreciation would have to come from further spread contraction, and that certainly can't be counted upon.

The credit investors of today clearly aren't gun-shy, leaving investment opportunities to languish at excessive yields and yield spreads. At best these investments are fairly priced today in relative terms and fully priced – offering low returns like everything else – in absolute terms.

I'll use an example to illustrate the acceptance being accorded low-grade credit instruments. In early May, Netflix issued €1.3 billion of Eurobonds, the lowest-cost debt it ever issued. The interest rate was 3.625%, the covenants were few, and the rating was single-B. Netflix's GAAP earnings run about $200 million per quarter, but according to *Grant's Interest Rate Observer*, in the year that ended March 31, Netflix burned through $1.8 billion of free cash flow. It's an exciting company, but as *Grant's* reminded its readers, bondholders can't participate in gains, just losses. **Given this asymmetrical proposition, any bond issue should be characterized by solidity and a meaningful promised return, not the sex appeal of its issuer.**

Is it prudent to lend money to a company that goes through it at such a prodigious rate? Will Amazon or Google be able to loosen Netflix's hold on its customers? Is it wise to buy bonds based on a technology position that could be overtaken? Positive investor sentiment has taken the company's equity value to $70 billion; what would happen to the bond price if worries about rising competition took a bite out of that one day**? Should you take these risks to make less than 4% per year? In Oaktree's view, this isn't a solid debt investment; it's an equity-linked digital content investment totally lacking in upside potential, and it's not for us. The fact that deals like this can get done easily should tell you something about today's market climate.**

Finally, let's consider whether risk tolerance and carefree behavior are isolated or widespread in today's credit market. Here are some quotes from a July 14 article by Lisa Abramowicz of *Bloomberg Gadfly* (emphasis added):

> Over the last eight years, junk-rated corporate debt has been transformed from a fringe asset to a staple for many fixed-income investors. As they've become more popular, these risky bonds and loans have increasingly lost a feature that made them so attractive (and lucrative) – the investor protections known as covenants written into the documents that govern the debt. These are aimed at ensuring investors can recover their money if the company fails.
>
> Last month, the $26.9 billion of junk bonds sold had the highest proportion of deals on record with weak investor protections, Moody's Investor Service reported this week. About 60 percent of the risky U.S. corporate bonds sold had few protections written into their deal documents, Moody's said. In the leveraged-loan market, nearly three quarters of the debt is "covenant lite" after three years of record issuance . . .
>
> **Investors have grown so confident about the seemingly interminable corporate-debt rally that many are dismissing the likelihood of large swaths of risky companies going bankrupt. After all, these covenants usually don't matter until there's a problem.**

It's a standard cycle: cautious investing produces good performance in a salutary environment . . . which leads to a reduction of caution . . . which leads to bad performance when the environment turns less favorable. This is part of the race to the bottom I wrote about in 2008.

Emerging Market Debt

The emerging markets are another place where investor opinion fluctuates wildly and visibly. "Everyone knows" the emerging markets have more growth potential than the developed world, but attitudes regarding the realizability of that potential – and thus the price one should pay for it – gyrate wildly over time.

I described the phenomenon in "The Role of Confidence" (August 2013). When confidence is running high, the emerging markets are viewed as being just like developed markets, only faster-growing, meaning it's reasonable for their securities to sell at yields and p/e ratios like those in the developed world. But when confidence declines, it becomes clear that there are risks that don't exist in the developed world – like coups, institutionalized corruption, maxi-devaluation and debt repudiation – and thus significant valuation discounts are in order. Again, as with corporate credit, which is this? **Are investors appropriately sensitive to the risks and imposing reasonable discounts, or are they ignoring the risks and happily paying up?** That's a lot of what you have to know.

To answer the question, I'll make reference to $2.75 billion of bonds that were issued by Argentina in mid-June. The maturity was 100 years – "century bonds" – and the interest rate was 8%.

> You might have thought this would be a hard thing to sell. After all, Argentina had defaulted on its debts eight times in its 200-year history, with no fewer than five defaults in the past century alone, most recently in 2014 amid a legal dispute with the Elliott hedge fund. . . .
>
> But investors do not seem to care: there were $9.75bn of bids. And Argentina is not the only peculiar event in bond markets this month. Take a look, for example, at Ivory Coast. In recent weeks, this West African nation underwent yet another military uprising. But this month it sold 16-year bonds with a 6.25 per cent yield – and these were also heavily oversubscribed. Places such as Senegal and Egypt have also seen hot demand for their debt. (*Financial Times*, June 27)

To conclude on this subject, I can't resist citing (but am too polite to name) the head of research and strategy for a likewise-unnamed broker/investment bank:

> "It's just shocking that they exit default and their bond issue is a century bond," said [Ms. X]. . . Nevertheless, she is advising her clients to buy the bonds as at least a short term trade.

Let me get this straight: it's incredible that Argentina is able to issue this thing, but it's a good buy for a moment. **It's a sign of the times: "something may go wrong, but probably not soon."** I much prefer Warren Buffett's view: "If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes."

For only the third time in history, emerging market debt is selling at yields below those on U.S. high yield bonds. Is Argentina, a country that defaulted five times in the last hundred years (and once in the last five), likely to get through the next hundred without a rerun?

The essential bottom line in all investing is simple: is the risk premium at least adequate? Can we answer in the affirmative with regard to emerging market debt today?

<u>Private Equity</u>

In today's low-return world, it's clear that institutional investors needing 7-8% a year aren't likely to get it from Treasurys yielding 1-2%, high grades at 3-4%, or mainstream stocks that most people expect to return 5-6%. *Heck, you can't even get it from Ivory Coast bonds!* Where is one to turn?

The good news for firms like Oaktree is that the answer is felt to most likely lie in what have come to be called "alternative investments" (there was no collective term for them when my partners and I started off 30 years ago). Since essentially no public "beta" markets offer the returns institutions need, many have turned instead to so-called "alpha strategies," where skillful, active management has the potential to augment market returns, producing what's needed.

But one of the biggest alternatives categories – hedge funds – has been largely discredited as a result of the meager average return over the last dozen years. And some of the others, like venture capital, are hard to access and too small to absorb much capital. That brings investors mainly to real estate, distressed debt and, especially, private equity.

Private equity firms market double-digit return track records, and even their top-of-the-cycle 2005-07 funds now sport respectable gains. As a result, they're attracting capital at all-time-high rates:

> Private equity is experiencing the best fundraising climate in years – perhaps ever. In the first half of the year, 224 North America-focused funds closed, raising $133 billion, while globally there have been 412 private equity funds closed, which raised a combined $221.4 billion, surpassing slightly the record $220.8 billion raised in 2008, according to Preqin. (*Mergers & Acquisitions* newsletter)

Private equity funds have been raising total capital in the hundreds of billions for the last few years, and even before the latest spate of mega-funds, they already had several hundred billion of "dry powder." Importantly, since private equity managers mostly engage in <u>leveraged</u> buyouts, these amounts have to be viewed in terms of the levered-up total capital they'll produce. Thus the PE firms will probably add more than a trillion dollars to their buying power this year. Where will it be invested at a time when few assets can be bought at bargain prices? Sellers of private companies, too, tend to set asking prices for their firms based on what cash flows are worth in this low-return world.

I'm not saying private equity isn't a solution, or even that it's not the best solution. It's just that **its record fund-raising is yet one more sign of the willingness of investors to trust in the future.**

<u>SoftBank Vision Fund</u>

Perhaps the ultimate demonstration of faith in fund managers is SoftBank's recent raising of $93 billion for its Vision Fund for technology investments – presumably on the way to $100 billion. SoftBank is a Japanese telecom company showing an 18-year annual return of 44% on investments that have included chipmakers, ride-hailing and telecom. But I see issues with the fund:

First, SoftBank's record of investment success has relied heavily on one phenomenal investment. The $20 million Softbank invested in Alibaba in 2000 has grown in value to more than $50 billion. **Skill or luck? And extrapolatable?**

Second, size matters. In 1999/2000, the venture capital industry got into trouble because it followed massively successful mid-1990s funds of hundreds of millions, with funds of $1-2 billion. The Vision Fund isn't for startups, but still, can you wisely invest $100 billion in technology?

Third, here's an organization that has never managed money for third parties, starting the biggest fund in history to do just that. Is their experience transferrable? **In all these regards I think the fund indicates a high level of enthusiasm and a low level of skepticism.**

Fourth, and perhaps more importantly for my purposes here, I want to spend some time on the fund's structure. For each 38 cents they put into the fund's equity, outside investors are required to put 62 cents into preferred units of the fund. On the other hand, SoftBank itself invested $28 billion in equity but nothing in preferred.

- That means when the fund reaches $100 billion, SoftBank will have put up only 28% of the capital but will own 50% of the equity. Adding in management fees and carried interest, its 28% of the capital may give it 60-70% of the gains.
- Even the private equity industry – with its willingness to take risk – has traditionally shied away from piling debt on technology companies (although less so lately). SoftBank doesn't hesitate to lever its tech investments.
- The preferred units will pay a 7% annual coupon. Lending money to a tech fund at that modest rate apparently is part of the price demanded of the LPs for an opportunity to invest in the fund's equity. I can imagine the sales pitch about how lucky the LPs are to get a chance to provide leverage for their own investment, but I doubt I'd be convinced.
- Finally, as the *Financial Times* wrote on June 11:

  > While the preferred unit holders will eventually receive their principal back [plus 7% per year], they will only receive [an equity] return for the equity portion of their investment in the fund.
  >
  > All outside backers of the fund are receiving 62 per cent in preferred units and the rest in equity, allowing them to reduce their downside risk, while still generating a good return.

  Sounds good on the surface. But how much does this diversion of the investors' capital into preferred units really reduce their downside risk? **The *FT* says investors in the preferred units "will eventually receive their principal back." Should that really be "will," or perhaps "may" or "hopefully will"?** Does a $100 million investment in the fund put only the $38 million of equity at risk, or is there risk associated with the preferred, too? I guess I don't consider the preferred units as rock-solid as the *FT* suggests. Aren't they more like the Netflix bonds: tech-linked downside with no upside? Would an arm's-length lender give an LP money at 7% to lever his equity in this fund 1.6 times?

The willingness of investors to invest in a shockingly large fund for levered tech investing with a questionable structure is a further indication of an exuberant, unquestioning market.

Digital Currencies

The discussion of innovative investments brings me to Bitcoin, Ether and other digital currencies. I'd guess these things have arisen from the intersection of (a) doubts about financial security – including the value of national currencies – that grew out of the financial crisis and (b) the comfort felt by millennials regarding all things virtual. But they're not real.

Some businesses accept Bitcoin as payment. Some buyers want to own Ether because it can be used to pay for computing power on the Ethereum network. Some people are eager to speculate on digital currency for profit. Others want to put a little money into these to-date-profitable phenomena rather than run the risk of missing out. But they're not real!

People tell me these currencies are solid, because (a) they're secure against hacking and counterfeiting and (b) the software used to generate them strictly limits the amount that can be created. **But they're not real!!!!!** Nobody has been able to make sense to me of these currencies. Here are a few paragraphs on Ether from *The New York Times* of June 19:

> The sudden rise of Ethereum highlights how volatile the bewildering world of virtual currency remains, where lines of code can be spun into billions of dollars in a matter of months. . . .
>
> Ethereum was launched in the middle of 2015 by a 21-year-old college dropout, Vitalik Buterin . . . Mr. Buterin was inspired by Bitcoin, and the software he built shares some of the same basic qualities. Both are hosted and maintained by the computers of volunteers around the world, who are rewarded for their participation with new digital tokens that are released into the network every day.
>
> Because the virtual currencies are tracked and maintained by a network of computers, no government or company is in charge. The prices of both Bitcoin and Ether are established on private exchanges, where people can sell the tokens they own at the going market price. . . .
>
> Many [new currency] applications being built on Ethereum are also raising money using the Ether currency, in what are known as initial coin offerings, a play on initial public offerings.
>
> Start-ups that have followed this path have generally collected Ether from investors and exchanged them for units of their own specialized virtual currency, leaving the entrepreneurs with the Ether to convert into dollars and spend on operational expenses.
>
> These coin offerings, which have proliferated in recent months, have created a surge of demand for the Ether currency. Just last week, investors sent $150 million worth of Ether to a start-up, Bancor, that wants to make it easier to launch virtual currencies.

Bottom line: you can use the imaginary currency Ether to buy other new imaginary currencies, or to invest in new companies that will create other new currencies. In "bubble.com," I highlighted some illogical aspects of e-commerce by including some of my father's old jokes regarding how to make money. Here's another that seems 100% appropriate for the digital currency movement:

> Two guys meet in the street. Joe tells Bob about the hamster he has for sale: pedigreed and highly intelligent. Bob says he'd like to buy a hamster for his kid: "How much is it?" Joe answers, "half a million," and Bob tells him he's crazy.
>
> They meet again the next day. "How'd you do with that hamster?" Bob asks. "Sold it," says Joe. "Did you get $500,000?" Bob asks. "Sure," says Joe. "Cash?" "No," Joe answers, "I took two $250,000 canaries."

One of my very favorite quotes concerning the market's foibles, from John Kenneth Galbraith, says that in euphoric times, **"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 the insight to appreciate the incredible wonders of the present."**

Maybe I'm just a dinosaur, too technologically backward to appreciate the greatness of digital currency. But it is my firm view that **the ability of these things to gain acceptance is just one more proof of the prevalence today of financial naiveté, willing risk-taking and wishful thinking**.

In my view, digital currencies are nothing but an unfounded fad (or perhaps even a pyramid scheme), based on a willingness to ascribe value to something that has little or none beyond what people will pay for it. But this isn't the first time. The same description can be applied to the Tulip mania that peaked in 1637, the South Sea Bubble (1720) and the Internet Bubble (1999-2000).

Serious investing consists of buying things because the price is attractive relative to intrinsic value. Speculation, on the other hand, occurs when people buy something without any consideration of its underlying value or the appropriateness of its price, solely because they think others will pay more for it in the future.

It isn't unreasonable for someone to use Bitcoin to pay for something – or for a seller to accept Bitcoin in payment – based on an agreement between the parties: barter takes place all the time. But does that make it "currency"?

The price of Bitcoin has more than doubled since the start of the year. Can something that does that seriously be considered a "medium of exchange" or "store of value," rather than the subject of a speculative mania? Maybe not, but Bitcoin looks staid in comparison to Ether, which has appreciated 4,500% so far this year. The outstanding Ether is now worth 82% as much as all the Bitcoin in the world, up from 5% at the beginning of the year.

The New York Times notes that together, the outstanding Bitcoin and Ether are worth more than Paypal and almost as much as Goldman Sachs. Would you rather own all of the two digital currencies or one of those companies? In other words, are these currencies' values real? They're likely to keep working as long as optimism is present, but their performance in bad times is far from dependable. **What will happen to Bitcoin's price and liquidity in a crisis if people decide they'd rather hold dollars (or gold)?**

<u>We Agree, But . . .</u>

Andrew told me about a conversation he had recently with some fund managers, in which he went over a lot of what I'm discussing here. Given today's conditions, their response started predictably: "We agree, but . . ."

We hear a lot of that these days:

- We agree, but the things we're doing offer higher returns than the rest.
- We agree, but cash isn't an option when it returns nearly nothing.
- We agree, but we can't take the risk of being out of the market.
- We agree, but there's no alternative.

Investors should choose their risk posture based on an assessment of what's being offered in terms of absolute return, absolute risk, and thus absolute risk-adjusted return. But today – on that famous other hand – investors generally don't have the luxury of holding out for absolute returns and safety like they enjoyed in the past.

Many of the things I've highlighted above offer good returns and risk premiums relative to the returns on Treasurys and high grade debt. But (a) low rates may be – generally are expected to be – a temporary condition and (b) it might be wiser to gauge reward in absolute terms. **The bottom line is that while the prices and prospective returns on many things are justifiable today relative to other things, you can't eat (or spend) relative returns.**

Everyone's investing on the basis of relatives these days; they see no alternative. But that reminds me of former Citigroup CEO Chuck Prince, who gained fame in the months leading up to the Global Financial Crisis for saying of the bank's leveraged lending practices, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." **Today I think most investors know the good times will end someday, as Prince did, but for now they feel they, too, have no choice but to dance.**

And there's one other thing we hear a lot these days:

- We agree things can't go well forever – we agree the cycle is extended, prices are elevated and uncertainty is high – but we don't see anything that's likely to bring the bull market to a close anytime soon.

In other words, there'll be a time for caution, just not today. In that connection, Andrew reminds me about Saint Augustine, who said: "Give me chastity and continence, but not yet." **Is there something other than the punitive returns on safe assets that keeps this from being a time for caution?**

Observations and Implications

As I said, most of the phenomena described above seem reasonable given the rest of what's going on in today's economic and financial world. But step back for perspective and put them together, and what do we see?

- Some of the highest equity valuations in history.
- The so-called VIX index of fear at an all-time low.
- The elevation of a can't-lose group of stocks.
- The movement of more than a trillion dollars into value-agnostic investing.
- The lowest yields in history on low-rated bonds and loans.
- Yields on emerging market debt that are lower still.
- The most fundraising in history for private equity.
- The biggest fund of all time raised for levered tech investing.
- Billions in digital currencies whose value has multiplied dramatically.

I absolutely am not saying stocks are too high, the FAANGs will falter, credit investing is risky, digital currencies are sure to end up worthless, or private equity commitments won't pay off.

All I'm saying is that for all the things listed above to simultaneously be gaining in popularity and attracting so much capital, credulousness has to be high and risk aversion has to be low. It's not that these things are doomed, just that their returns may not fully justify their risk. And, more importantly, that they show the temperature of today's market to be elevated. Not a nonsensical bubble – just high and therefore risky.

Try to think of the things that could knock today's market off kilter, like a surprising spike in inflation, a significant slowdown in growth, central banks losing control, or the big tech stocks running into trouble. The good news is that they all seem unlikely. The bad news is that their unlikelihood causes all these concerns to be dismissed, leaving the markets susceptible should any of them actually occur. **That means this is a market in which riskiness is being tolerated and perhaps ignored, and one in which most investors are happy to bear risk. Thus it's not one in which we should do so.**

What else:

- My observations are always indicative, not predictive. **The usual consequences of the conditions I describe – like an eventual increase in risk aversion – should happen, but they don't have to happen.**
- **And they certainly don't have to happen soon.** No one knows anything about timing. Certain consequences are implied, but even if they're going to happen, we have no way of knowing when. It feels like we're in the eighth inning, but I have no idea how long the game will go on.
- **I'm never sure of my market observations.** As you'll see in my new book, I believe strongly that where we are in a cycle says a lot about the market's likely tendencies, but I never state opinions on this subject with high confidence.
- **As a natural worrier, I tend to be early with warnings**, as described on page one. 'Nuff said.
- **Finally, while my observations are uncertain and should be taken with a grain of salt, what I am sure of is that valuations and markets are elevated, and the easy money in this cycle has been made.**

What to Do

To me, the four components of the current environment listed on pages 2 and 3 – high uncertainty, low prospective returns, high prices and pro-risk behavior – are indisputable. The question is whether you agree. If so, I trust you'll grant that they make for a troubling combination. Markets normally respond to elevated uncertainty with lower asset prices and compensatorily higher returns. But not today. Thus we're living in a low-return, high-risk world. Period.

For that reason, this might seem like an attractive time to refrain from investing, or at least from bearing risk. However, organizations for which investing is an essential part of the business model – like pension funds, insurance companies, endowments and sovereign wealth funds – generally don't have the option to not invest. That's especially true when the return on cash is as low as it is today.

Further, the case for cash that can be built today from all the above could have been made years ago, and doing so would have resulted in huge penalties. Oaktree's investment philosophy generally causes us to eschew the raising and lowering of cash. We might make an exception in extraordinary circumstances, but today doesn't seem to warrant doing so. **Instead, Oaktree will continue to follow its 2012 mantra: "move forward, but with caution" – and, given today's conditions, with even more caution than in the recent past. If one is going to invest at times like this, investment professionalism – knowing how to bear risk intelligently, striving for return while keeping an eagle-eye on the potential adverse consequences – is the absolute *sine qua non.***

Environments like today's call to mind the applicability of something I was told more than 40 years ago by Sid Cottle, editor of the later editions of Graham and Dodd's *Security Analysis*: **"Investment is the discipline of relative selection."** I interpret that to mean we have no alternative but to choose from among the available options based on their relative merit.

"There They Go Again" was written in May 2005, at the front end of a string of cautionary memos leading up to the last cyclical peak. It was the first time I explicitly raised the question – too early as usual – of how one should invest in a low-return world. I went on to list a few possibilities, none of which was sure to work, but I concluded with the one thing I was convinced of:

> . . . there's no easy answer for investors faced with skimpy prospective returns and risk premiums. But there is one course of action – one classic mistake – that I most strongly feel is wrong: **reaching for return**.

The events of 2007 and 2008 showed this observation to have been prudent and appropriate. And given today's similarities to the last cycle, I think it's applicable again.

Here's a great observation on the subject from Berkshire-Hathaway's 2010 letter to shareholders:

> We agree with investment writer Ray DeVoe's observation, "More money has been lost reaching for yield than at the point of a gun."

Or as Peter Bernstein put it, "The market is not an accommodating machine; it won't give you high returns just because you need them."

The key strategic decision for anyone shaping investment strategy is whether to apply aggressiveness or defensiveness at a given point in time. In other words, should we worry more today about losing money or about missing opportunity? The answer at all times depends on what's available in the investment environment.

- I have no doubt that the ascent to the apex from which the Global Financial Crisis took place was powered by the willing acceptance of risk in the low-return world of 2004-07. **In other words, excessive risk tolerance and the resulting incautious behavior provided the foundation for the vast losses experienced in the move from peak to trough.**

- And in the trough of late 2008/early '09, I likewise have no doubt that most investors were saying, "I don't care if I ever make another penny in the market; I just don't want to lose any more. Get me out!" **Their excessive risk aversion created the opportunity for the huge returns enjoyed in the recovery.**

Where are we today? As I said earlier, risk is high and prospective return is low, and the low prospective returns on safe investments are pushing people into taking risk – which they're willing to do – at a time when the reward for doing so is low.

Given my view of the environment, the only reason to be aggressive today is because defensive investing implies low prospective returns. But the question is whether pursuing high expected returns through aggressiveness can be counted on to be rewarded. If the answer is no, as I believe, then this is a time for caution.

That doesn't mean you have to be content with a low-return portfolio. If you need returns higher than those available in the beta markets at the low-risk end of the spectrum, it is reasonable to move into riskier asset classes. **But for every asset class, there are high-risk and low-risk approaches. When the market is rational, low-risk investments will always appear to offer prospective returns lower than those on high-risk ones. But in tough times, the former are less likely to bring losses than the latter. In my opinion that makes them right for today.**

*   *   *

Perhaps the best way to understand investment cycles is through that great statement attributed to Mark Twain: "History doesn't repeat, but it does rhyme." The duration, pace, amplitude and details of each investment cycle are different from those of its predecessors, but the basic themes and essential ingredients are usually vaguely familiar. What Twain calls rhyming history I describe as "common threads."

The themes or threads that repeatedly characterize too-bullish markets are the ones listed on page 4. **While they don't all have to be present for a top, bull market or boom to form, (a) usually many are present when one does and (b) it's hard for a full-throated bubble to come into existence without them. They truly are the raw materials for market excesses on the upside.**

On the other hand, the keys to avoiding the classic mistakes also recur, and I listed them in "There They Go Again":

- awareness of history,
- belief in cycles rather than unabated, unidirectional trends,
- skepticism regarding the free lunch, and
- insistence on low purchase prices that provide lots of room for error.

> Adherence to these things – all parts of the canon of defensive investing – invariably will cause you to miss the most exciting part of bull markets, when trends reach irrational extremes and prices go from fair to excessive. **But they'll also make you a long-term survivor. I can't help thinking that's a prerequisite for investment success.**

The checklist for market sanity and safety is simple, and the answers will tell you what to do:

- Are prospective returns adequate?
- Are investors appropriately risk-averse?
- Are they applying skepticism and discipline?
- Are they demanding sufficient risk premiums?
- Are valuations reasonable relative to historic standards?
- Are deal structures fair to investors?
- Are investors declining any of the new deals?
- Are there limits on faith in the future?

The basic proposition is simple: Investors make the most and the safest money when they do things other people don't want to do. But when investors are unworried and glad to make risky investments (or worried but investing anyway, because the low-risk alternatives are unappealing), asset prices will be high, risk premiums will be low, and markets will be risky. That's what happens when there's too much money and too little fear.

I'll close with a final "ditto," from "The Race to the Bottom" of just over ten years ago:

> If you refuse to fall into line in carefree markets like today's, it's likely that, for a while, you'll (a) lag in terms of return and (b) look like an old fogey. But neither of those is much of a price to pay if it means keeping your head (and capital) when others eventually lose theirs. In my experience, times of laxness have always been followed eventually by corrections in which penalties are imposed. It may not happen this time, but I'll take that risk. In the meantime, Oaktree and its people will continue to apply the standards that have served us so well over the last [thirty] years.

July 26, 2017

Legal Information and Disclosures

Memo to: Oaktree Clients

From: Howard Marks

Re: Yet Again?

"There They Go Again . . . Again" of July 26 has generated the most response in the 28 years I've been writing memos, with comments coming from Oaktree clients, other readers, the print media and TV. I also understand my comments regarding digital currencies have been the subject of extensive – and critical – comments on social media, but my primitiveness in this regard has kept me from seeing them.

The responses and the time that has elapsed have given me the opportunity to listen, learn and think. Thus I've decided to share some of those reflections here.

Media Reaction

The cable news shows and blogposts delivered a wide range of reactions – both positive and negative. The best of the former came from a manager who, when asked on TV what he thought of the memo, said, "I'd like to photocopy it and sign it and send it out as my quarterly letter." Love that guy.

I haven't spent my time reveling in the praise, but rather thinking about those who took issue. (My son Andrew always reminds me about Warren Buffett's prescription: "praise by name, criticize by category." Thus no names.) Here's some of what they said:

1. "The story from Howard Marks is 'it's time to get out.' "
2. "He's right in the concept but wrong to execute right now."
3. "The market is a little expensive, but you should continue to ride it until there are a couple of big down days."
4. "There are stocks that are past my sell points, and I'm letting them continue to burble higher."
5. "I appreciate Howard Marks's message but I think now is no more a time to be cautious than at any other time. We should *always* invest as if the best is yet to come but the worst could be right around the corner. This means durable portfolios, hedges, cash reserves . . . etc. There is no better or worse time for any of these things that we can foresee in advance."

I take issue with all these statements, especially the last, and I want to respond – not just in the sense of "dispute," but rather to clarify where I stand. In doing so, I'll incorporate some of what I said during my appearances on TV following the memo's publication.

Numbers one and two are easy. As I explained on CNBC, there are two things I would never say when referring to the market: "get out" and "it's time." I'm not that smart, and I'm never that sure. The media like to hear people say "get in" or "get out," but most of the time the correct action is somewhere in between.

I told Bloomberg, "Investing is not black or white, in or out, risky or safe." **The key word is "calibrate." The amount you have invested, your allocation of capital among the various possibilities, and the riskiness of the things you own all should be calibrated along a continuum that runs from aggressive to defensive.**

And as I told CNBC, what matters is "the level that securities are trading at and the emotion that is embodied in prices." Investors' actions should be governed by the relationship between each asset's price and its intrinsic value. **"It's not what's going on; it's how it's priced. . . . When we're getting value cheap, we should be aggressive; when we're getting value expensive, we should pull back**."

Here's how I summed up on Bloomberg:

> It's all about investors' willingness to take risk as opposed to insisting on safety. And when people are highly willing to take risk, and not concerned about safety, that's when I get worried.

If it's true, as I believe, that (a) the easy money in this cycle has been made, (b) the world is a risky place, and (c) securities are priced high, then people should probably be taking less risk today than they did three, five or seven years ago. Not "out," but "less risk" and "more caution."

And from my visit to CNBC:

> All I'm saying is that prices are elevated; prospective returns are low; risks are high; people are engaging in risky behavior. Now nobody disagrees with any of the four of those, and if not, then it seems to me that this is a time for increased caution. . . . It's maybe "in, but maybe a little less than you used to be in." Or maybe "in as much as you used to be in, but with less-risky securities."

Numbers three and four – arguing that it's too early to sell even if the market is expensive or holdings are past their sell point – are interesting. They're either (a) absolutely illogical or (b) signs of the investor error and lack of discipline that are typical in bull markets.

- If the market is expensive, why wouldn't you lighten up?
- Why would you prefer to sell after a few big down days, rather than today? (What if the big down days are the start of a slide so big that you can't get out at anything close to fair value? What if there's a big down day followed by a big up day that gets you right back where you started? Does the process re-set? And is it three big down days in a row, or four?)
- And if you continue to hold past your sell points, what does "sell point" mean?

Bottom line: I think these things translate into "I want to think of myself as disciplined and analytical, but even more I want to make sure I don't miss out on further gains." In other words, fear of missing out has taken over from value discipline, a development that is a sure sign of a bull market.

The fifth and final comment – that one should exercise the same degree of care and risk aversion at all times – gives me a lot to talk about. In working on my new book, I divided the things an investor can do to achieve above average performance into two general categories:

- selection: trying to hold more of the things that will do better and less of the things that will do worse, and
- cycle adjustment: trying to have more risk exposure when markets rise and less when they fall.

Accepting that "there is no better or worse time" simply means giving up on the latter. Whereas Buffett tells us to "be fearful when others are greedy and greedy when others are fearful" – and he's got a pretty good track record – this commentator seems to be saying we should be equally greedy (and equally fearful) all the time.

I feel strongly that it's possible to improve investment results by adjusting your positioning to fit the market, and Oaktree was able to do so by turning highly cautious in 2005-06 and highly aggressive in 1990-91, 2001-02 and immediately after the Lehman bankruptcy filing in 2008. This was done on the basis of reasoned judgments concerning:

- how markets have been acting,
- the level of valuations,
- the ease of executing risky financings,
- the status of investor psychology and behavior,
- the presence of greed versus fear, and
- where the markets stand in their usual cycle.

Is this effort in conflict with the tenet of Oaktree's investment philosophy that says macro-forecasting isn't key to our investing? My answer is an emphatic "no." **Importantly, assessing these things only requires observations regarding the present, not a single forecast.**

As I say regularly, "We may not know where we're going, but we sure as heck ought to know where we stand." Observations regarding valuation and investor behavior can't tell you what'll happen tomorrow, but they say a lot about where we stand today, and thus about the odds that will govern the intermediate term. They can tell you whether to be more aggressive or more defensive; they just can't be expected to always be correct, and certainly not correct right away.

The person who said "there is no better or worse time" was on TV with me, giving me a chance to push back. What he meant, he said, was that the vast majority of people lack the ability to discern where we stand in this regard, so they might as well not try.

I agree that it's hard. **Up-and-down cycles are usually triggered by changes in fundamentals and pushed to their extremes by swings in emotion. Everyone is exposed to the same fundamental information and emotional influences, and if you respond to them in a typical fashion, your behavior will be typical: pro-cyclical and painfully wrong at the extremes. To do better – to succeed at being contrarian and anti-cyclical – you have to (a) have an understanding of cycles, which can be gained through either experience or studying history, and (b) be able to control your emotional reaction to external stimuli.** Clearly this isn't easy, and if average investors (i.e., the people who drive cycles to extremes) could do it, the extremes wouldn't be as high and low as they are. But investors should still try. If they can't be explicitly contrarian – doing the opposite at the extremes (which admittedly is hard) – how about just refusing to go along with the herd?

Here's what I wrote with respect to the difficulty of doing this in "On the Couch" (January 2016):

> I want to make it abundantly clear that when I call for caution in 2006-07, or active buying in late 2008, or renewed caution in 2012, or a somewhat more aggressive stance here in early 2016, I do it with considerable uncertainty. My conclusions are the result of my reasoning, applied with the benefit of my experience (and collaboration with my Oaktree colleagues), but I never consider them 100% likely to be correct, or even 80%. **I think they're right, of course, but I always make my recommendations with trepidation**.

When widespread euphoria and optimism cause asset prices to meaningfully exceed intrinsic values and normal valuation metrics, at some point we must take note and increase caution. And yet, invariably, the market will continue to march upward for a while to even greater excesses, making us look wrong. **This is an <u>inescapable</u> consequence of trying to know where we stand and take appropriate action.** But it's still worthwhile. Even though no one can ascertain when we're at the exact top or bottom, a key to successful investing lies in selling – or lightening up – when we're closer to the top, and buying – or, hopefully, loading up – when we're closer to the bottom.

FAANGs

There's been a lot of discussion regarding my comments on the FAANGs – Facebook, Amazon, Apple, Netflix and Google – and whether they're a "sell." Some of them are trading at p/e ratios that are just on the high side of average, while others, sporting triple-digit p/e's, are clearly being valued more on hoped-for growth than on their current performance.

But whether these stocks should be sold, held or bought was never my concern. As I said on Bloomberg:

> My point about the FAANGs was not that they are bad investments individually, or that they are overvalued. It was that the anointment of one group of super-stocks is indicative of a bull market. **You can't have a group treated like the FAANGs have been treated in a cautious, pessimistic, sober market.** So that should not be read as a complaint about that group, but rather indicative [of the state of the market].

That's everything I have to say on the subject.

Bitcoin

As I said earlier, there has been particularly spirited response to my comments on digital currencies. It prompted me to sit down with people ranging from some of my Oaktree colleagues to Steven Bregman and Murray Stahl of Horizon Kinetics (my July memo incorporated some of Steven's observations on ETFs), and I learned that I've been looking at Bitcoin the wrong way. In particular, I realized that the memo incorporated the wrong joke from my father; instead of "the half-million-dollar hamster," it should have been this one:

> Two friends meet in the street, and Jim tells Sue he has some great sardines for sale. The fish are pedigreed and pure-bred, with full papers and high IQs. They were individually de-boned by hand and packed in the purest virgin olive oil. And the label was painted by a world-renowned artist.
>
> Sue says, "That sounds great. I could use a tin. How much are they?" and Jim tells her they're $10,000. Sue responds, "That's crazy, who would eat $10,000 sardines?" **"Oh," says Jim, "these aren't eating sardines; these are trading sardines."**

I had been thinking about digital currencies like Bitcoin as investing sardines, and that may have been a mistake. Their fans tell me they're spending sardines, and while that may be the case, I think at the moment they're being treated largely as trading sardines. The question remains open as to whether Bitcoin is (a) a currency, (b) a payment mechanism, (c) an asset class, or (d) a medium for speculation.

The main complaint expressed in my memo was as follows:

> Serious investing consists of buying things because the price is attractive relative to intrinsic value. Speculation, on the other hand, occurs when people buy something without any consideration of its underlying value or the appropriateness of its price, solely because they think others will pay more for it in the future.

In the memo I talked about Bitcoin as an investment asset that should have a value that can be appraised. While its fans tell me this isn't the right way to view it, I note that in their February "Bitcoin Review," even Steven and Murray called it "a new asset class." I think this is the weakest claim being made about Bitcoin. As I said in the memo, "it's not real" – there is no intrinsic value behind it.

What Bitcoin partisans have told me subsequently is that Bitcoin should be thought of as a currency – a medium of exchange – not an investment asset. Given that the evolution of Bitcoin is so topical, I think further discussion is in order. To start, I'm going to present the case for it as a currency. What are the characteristics of a currency?

- **Most importantly, it's something that people agree can be used as legal tender** (to buy things and pay debts), used as a store of value, and exchanged for other currencies.
- Currencies generally are created by governments. However, there have been exceptions: banks issued their own currencies in our nation's first century, and it can be argued that the "Green Stamps" of my childhood, and airline miles today, have a lot in common with currencies.
- For a long time currencies were backed by (and exchangeable for) gold or silver, but that's no longer the case. The truth is, there's nothing behind currencies these days other than their issuing governments' "full faith and credit." But what do they promise? New currencies are sometimes created out of thin air (like the euro, which wasn't legal tender sixteen years ago), and sometimes they're devalued.
- Currencies change in value relative to each other, in theory based on differential purchasing power, and in practice based on changes in supply and demand (which can stem, among other things, from changes in purchasing power).

Bitcoin fans argue that it qualifies as a currency under these criteria: most importantly, it's something that parties can agree to accept as legal tender and a store of value. That actually seems right.

When I first responded to comments on the memo – even before my recent enlightenment – I found myself admitting that much of the criticism I had leveled at Bitcoin is applicable to the dollar as well. Whereas I said Bitcoin "isn't real" because it has no intrinsic or underlying value, that's certainly true of the dollar and other fiat currencies: there's nothing behind them either. You can no longer exchange them for gold (and what is gold, anyway? But that's another subject). In fact, government-issued fiat currencies are accorded value only because of a government edict. **Why, the fans of Bitcoin ask, is such an edict superior to an agreement among people to accept a non-government-issued currency? Fiat currencies have value simply because of faith in the governments that issue them. If enough people believe in it, why can't faith in Bitcoin suffice? If you consider the properties of fiat currencies, these are darn good questions.**

So my initial bottom line is that I see no reason why Bitcoin can't be a currency, since it shares the characteristics listed above, especially the fact that there are people (and businesses and even countries) that accept it as legal tender.

But that's not good enough for Bitcoin's fans. **It's not the same as the dollar, they say; it's better.** In all the following ways, they've told me, Bitcoin is superior to government-issued currency:

- All the relevant data regarding Bitcoin – number outstanding, number newly created, and transactions – are recorded in the "blockchain," a sort of transparent electronic ledger of which everyone can have his or her own copy.
- Bitcoin can't be debased by unlimited issuance, since the blockchain process has been set to permit only a gradual increase from today's 16 million, to 21 million in 2140. In this sense Bitcoin is better than the dollar, of which a lot more can be issued at any time, diminishing its purchasing power through inflation. As Steven and Murray have written, "a purchase of Bitcoin is nothing other than a short sale of the currencies of the world. Merely by limiting the growth of supply, Bitcoin would become more valuable as other currencies devalue."
- Since the blockchain exists on each person's individual computer, rather than in a central location, it can't be hacked, and thus Bitcoin can't be stolen, counterfeited, or secretly created in amounts exceeding the authorized total. Likewise, Bitcoin isn't subject to the currency controls on portability that are often imposed by failing governments. (But I wonder whether the technological claims made for the blockchain might be its Achilles' heel. While I certainly don't have the ability to assess these claims for myself, I wonder how many of Bitcoin's advocates do either.)

Where will we go from here? The partisans claim the outlook for Bitcoin as a currency is bright:

- Since very few people own it today but millions more will want it in the future, demand is sure to rise faster than supply, meaning the price will rise.
- Specifically, the U.S. money supply is almost $14 trillion, so if people and businesses decide to hold just one-third of their wealth in Bitcoin rather than dollars, (and who wouldn't want to do so given all the advantages described above?), the value of the Bitcoin in circulation will rise to $4.5 trillion, from today's $73 billion, for a gain of roughly 60x.
- There's sure to be a network effect: the more people join the Bitcoin movement, the more it will be accepted as legal tender, the more useful it will be, and the more demand will increase.
- Ignoring Bitcoin's utility as currency, many people will buy just because they believe someone else will pay them more for it. (This time-honored "greater-fool theory" lies at the heart of all speculative manias.) Likewise, people will buy it because of fear of missing out, another bull-market standard.

There's absolutely no reason why Bitcoin – or anything else – can't serve as a currency if enough people accept it as such. While I'd point out that no private currency has gained widespread use in a long, long time, there's nothing to say it can't happen.

Being willing to agree that Bitcoin may become an accepted medium of exchange is not the same as saying you should buy it now to make money. Think about the fact that the price of Bitcoin has risen more than 350% so far this year and 3,900% in the last three years. To the degree people argue that Bitcoin is a currency, then (a) why is it so volatile? and (b) is that desirable? You might want to consider whether a real currency can do that, or whether speculative buying is determining Bitcoin's price. And whether what's gone up can come down.

The immediate issue of Bitcoin as a currency still comes down to the question of whether today's price is right. The price of a Bitcoin is around $4,600 today. Can one Bitcoin buy the same amount of goods as 4,600 dollar bills? Or the much higher amounts that Bitcoin bulls think it will soon be worth? I don't think we have enough information to know, but the question isn't irrelevant. If it were, this would be another case of "there's no price too high."

The other purported use for Bitcoin, given its status as what Marc Andreessen calls a "digital bearer instrument," is as a payment mechanism. Its advantages in this regard include the following:

- transactions in Bitcoin can be anonymous (I understand it is often used to pay for opioids),
- payments are made without fees like those charged on credit card transactions and wire transfers,
- there can't be fraud and merchant charge-backs like with credit cards, and
- it can be particularly useful in emerging nations lacking developed payment systems.

But I see two issues here:

- First, I expect there to be many competing transaction systems. Will the banks and other financial institutions cede this territory to Bitcoin? Wouldn't banks' systems be more likely to gain acceptance from people other than perhaps millennials? What would happen to Bitcoin's utility as a payment mechanism if Amazon announced its own? Would you rather transact in Bitcoin or Amazonians?
- Second, if Bitcoin were to become the leading non-governmental payment system, what would cause it to appreciate? If you want to pay me in Bitcoin and I'll accept it, what would cause its price to rise? Adherents would argue that the limited supply relative to the growing use will make the price rise. But that assumes there's no price so high for Bitcoin that transferees won't accept it in lieu of dollars. The "pro" side of the argument foresees limitless appreciation, but that doesn't make sense. Think of any other currency: isn't there a price at which you wouldn't accept it? Would you sell your house for euros that are said to be worth two or three times as much as the dollar?

Marc Andreessen wrote an excellent article in The New York Times' *Dealbook*, titled "Why Bitcoin Matters" (January 21, 2014). The article outlined Bitcoin's potential as a payment system and described many of the advantages listed above. But it didn't include one word about why these advantages give Bitcoin appreciation potential.

So what's my real bottom line?

- Advocates say if Bitcoin is accepted as described above, you'll make more than 50 times your money. Thus success doesn't have to be highly probable for buying Bitcoin to have a huge expected return. **This is called "lottery-ticket thinking," under which it seems smart to bet on an improbable outcome that offers a huge potential payoff.** We saw it in full flower in the dot-com boom in 1999-2000, and I think we're seeing it in action again today with regard to Bitcoin. Nothing is as seductive as the possibility of vast wealth.
- Several of the "seeds for a boom" that I listed in "There They Go Again . . . Again" are at work in the Bitcoin surge: (a) there is **a grain of underlying truth** as set out above; (b) there's **the prospect of a virtuous circle**: widespread demand will lead to wider acceptance as legal tender, which will lead to widespread demand; and (c) thus **this tree may grow to the sky,** as there is no obvious limit to this logic. None of these things necessarily make Bitcoin a mistake. They merely say elements that contributed to past bubbles can be detected today with regard to Bitcoin.
- Finally, Bitcoin isn't alone. There are hundreds of digital currencies already – including eleven with market capitalizations over a billion dollars – and no limits on the creation of new ones. So even if digital currencies are here to stay, who knows which one will turn out to be the winner? Hundreds of e-commerce start-ups appreciated rapidly in the tech bubble based on the premise that "the Internet will change the world." It did, but most of the companies ended up worthless.

Thanks to the people who took the time to educate me, I'm a little less of a dinosaur regarding Bitcoin than I was when I wrote my last memo. I think I understand what a digital currency is, how Bitcoin works, and some of the arguments for it. But I still don't feel like putting my money into it, because I consider it a speculative bubble. I'm willing to be proved wrong.

Passive Investing

Passive investing can be thought of as a low-risk, low-cost and non-opinionated way to participate in "the market," and that view is making it more and more popular. But I continue to think about the impact of passive investing **on** the market.

One of the most important things to always bear in mind is George Soros's "theory of reflexivity," which I paraphrase as saying that the efforts of investors to master the market affect the market they're trying to master. **In other words, how would golf be if the course played back: if the efforts of golfers to put their shot in the right place caused the right place to become the wrong place? That's certainly the case with investing.**

It's tempting to think of the investment environment as an unchanging backdrop, that is, an independent variable. Then all you have to do is figure out the right course of action and take it. But what if the environment is a dependent variable? Does the behavior of investors alter the environment in which they work? Of course it does.

The early foundation for passive or index investing lay in the belief that the efforts of active investors cause stocks to be priced fairly, so that they offer a fair risk-adjusted return. This "efficiency" makes it hard for mispricings to exist and for investors to identify them. "The average investor does average before fees," I was taught, "and thus below average after fees. You might as well throw darts."

There's less talk of dart-throwing these days, but much more money is being invested passively**. If you want an index's performance and believe active managers can't deliver it (or beat it) after their high fees, why not just buy a little of every stock in the index? That way you'll invest in the stocks in the index in proportion to their representation, which is presumed to be "right" since it is set by investors assessing their fundamentals.** (Of course there's a contradiction in this. Active managers have been judged to be unable to beat the market but competent to set appropriate market weightings for the passive investors to rely on. But why quibble?)

The trend toward passive investing has made great strides. Roughly 35% of all U.S. equity investing is estimated to be done on a passive basis today, leaving 65% for active management. However, Raj Mahajan of Goldman Sachs estimates that already a substantial majority of daily trading is originated by quantitative and systematic strategies including passive vehicles, quantitative/algorithmic funds and electronic market makers. In other words, just a fraction of trades have what Raj calls "originating decision makers" that are human beings making fundamental value judgments regarding companies and their stocks, and performing "price discovery" (that is, implementing their views of what something's worth through discretionary purchases and sales).

What percentage of assets has to be actively managed by investors driven by fundamentals and value for stocks to be priced "right," market weightings to be reasonable and passive investing to be sensible? I don't think there's a way to know, but people say it can be as little as 20%. If that's true, active, fundamentally driven investing will determine stock prices for a long time to come. But what if it takes more?

Passive investing is done in vehicles that make no judgments about the soundness of companies and the fairness of prices. More than $1 billion is flowing daily to "passive managers" (there's an oxymoron for you) who buy regardless of price. I've always viewed index funds as "freeloaders" who make use of the consensus decisions of active investors for free. **How comfortable can investors be these days, now that fewer and fewer active decisions are being made?**

Certainly the process described above can introduce distortions. At the simplest level, **if all equity capital flows into index funds for their dependability and low cost, then the stocks in the indices will be expensive relative to those outside them.** That will create widespread opportunities for active managers to find bargains among the latter. **Today, with the proliferation of ETFs and their emphasis on the scalable market leaders, the FAANGs are a good example of insiders that are flying high, at least partially on the strength of non-discretionary buying.**

I'm not saying the passive investing process is faulty, just that it deserves more scrutiny than it's getting today.

<u>The State of the Market</u>

There has been a lot of discussion about how elevated I think the market is. I've pushed back strongly against people who describe me as "super-bearish." **In short, as I wrote in the memo, I believe the market is "not a nonsensical bubble – just high and therefore risky."**

I wouldn't use the word "bubble" to describe today's general investment environment. It happens that our last two experiences were bubble-crash (1998-2002) and bubble-crash (2005-09). But that doesn't mean every advance will become a bubble, or that by definition it will be followed by a crash.

- Current psychology cannot be described as "euphoric" or "over-the-moon." Most people seem to be aware of the uncertainties that are present and of the fact that the good times won't roll on forever.
- Since there hasn't been an economic boom in this recovery, there doesn't have to be a major bust.
- Leverage at the banks is a fraction of the levels reached in 2007, and it was those levels that gave rise to the meltdowns we witnessed.
- Importantly, sub-prime mortgages and sub-prime-based mortgage backed securities were the key ingredient whose failure directly caused the Global Financial Crisis, and I see no analog to them today, either in magnitude or degree of dubiousness.

It's time for caution, as I wrote in the memo, not a full-scale exodus. There is absolutely no reason to expect a crash. There may be a painful correction, or in theory the markets could simply drift down to more reasonable levels – or stay flat as earnings increase – over a long period (although most of the time, as my partner Sheldon Stone says, "the air goes out of the balloon much faster than it went in").

<u>Investing in a Low-Return World</u>

A lot of the questions I've gotten on the memo are one form or another of "So what should I do?" Thus I've realized the memo was diagnostic but not sufficiently prescriptive. I should have spent more time on the subject of what behavior is right for the environment I think we're in.

In the low-return world I described in the memo, the options are limited:

1. Invest as you always have and expect your historic returns.
2. Invest as you always have and settle for today's low returns.
3. Reduce risk to prepare for a correction and accept still-lower returns.
4. Go to cash at a near-zero return and wait for a better environment.
5. Increase risk in pursuit of higher returns.
6. Put more into special niches and special investment managers.

It would be sheer folly to expect to earn traditional returns today from investing like you've done traditionally (#1). With the risk-free rate of interest near zero and the returns on all other investments scaled based on that, I dare say few if any asset classes will return in the next few years what they've delivered historically.

Thus one of the sensible courses of action is to **invest as you did in the past but accept that returns will be lower**. Sensible, but not highly satisfactory. No one wants to make less than they used to, and the return needs of institutions such as pension funds and endowments are little changed. Thus #2 is difficult.

If you believe what I said in the memo about the presence of risk today, you might want to opt for #3. In the future people may demand higher prospective returns or increased prospective risk compensation, and the way investments would provide them would be through a correction that lowers their prices. **If you think a correction is coming, reducing your risk makes sense.** But what if it takes years for it to arrive? Since Treasurys currently offer 1-2% and high yield bonds offer 5-6%, for example, fleeing to the safety of Treasurys would cost you about 4% per year. What if it takes years to be proved right?

Going to cash (#4) is the extreme example of risk reduction. **Are you willing to accept a return of zero as the price for being assured of avoiding a possible correction?** Most investors can't or won't voluntarily sign on for zero returns.

All the above leads to #5: **increasing risk as the way to earn high returns in a low-return world**. But if the presence of elevated risk in the environment truly means a correction lies ahead at some point, risk should be increased only with care. As I said in the memo, every investment decision can be implemented in high-risk or low-risk ways, and in risk-conscious or risk-oblivious ways. High risk does not assure higher returns. It means accepting greater uncertainty with the goal of higher returns and the possibility of substantially lower (or negative) returns. I'm convinced that at this juncture it should be done with great care, if at all.

And that leaves #6. **"Special niches and special people,"** if they can be identified, can deliver higher returns without proportionally more risk. That's what "special" means to me, and it seems like the ideal solution. But it's not easy. Pursuing this tack has to be based on the belief that (a) there are inefficient markets and (b) you or your managers have the exceptional skill needed to exploit them. Simply put, this can't be done without risk, as one's choice of market or manager can easily backfire.

As I mentioned above, none of these possibilities is attractive or a sure thing. But there are no others. What would I do? For me the answer lies in a combination of numbers 2, 3 and 6.

Expecting normal returns from normal activities (#1) is out in my book, as are settling for zero in cash (#4) and amping up risk in the hope of draws from the favorable part of the probability distribution (#5) (our current position in the elevated part of the cycle decreases the likelihood that outcomes will be favorable).

Thus I would mostly do the things I always have done and accept that returns will be lower than they traditionally have been (#2). While doing the usual, I would increase the caution with which I do it (#3), even at the cost of a reduction in expected return. And I would emphasize "alpha markets" where hard work and skill might add to returns (#6), since there are no "beta markets" that offer generous returns today.

These things are all embodied in our implementation of the mantra that has guided Oaktree in recent years: "move forward, but with caution."

Since the U.S. economy continues to bump along, growing moderately, there's no reason to expect a recession anytime soon. As a consequence, it's inappropriate to bet that a correction of high prices and pro-risk behavior will occur in the immediate future (but also, of course, that it won't).

Thus Oaktree is investing today wherever good investment opportunities arise, and we're not afraid to be fully invested where there are enough of them. But we are employing caution, and since we're a firm that thinks of itself as always being cautious, that means more caution than usual.

This posture has served us extremely well in recent years. Our underlying conservatism has given us the confidence needed to be largely fully invested, and this has permitted us to participate when the markets performed better than expected, as they did in 2016 and several of the last six years. **Thus we'll continue to follow our mantra, as we think it positions us well for the uncertain environment that lies ahead.**

September 7, 2017

Legal Information and Disclosures

Memo to: Oaktree Clients

From: Howard Marks

Re: Latest Thinking

Travel to clients abroad and preoccupation with my coming book on cycles (final draft submitted just the other day) have combined to keep me from writing a memo since September, but fortunately not from thinking. Thus I have ideas to set down on two significant subjects: the market environment and the new tax law. Further, I'm highly motivated to do so, since if I skip a few months, people start writing in, "Are you sick?"

More on the Markets

As I wrote in September ("Yet Again?"), some readers of my July memo, "There They Go Again . . . Again," perceived my stance as ultra-bearish. This was epitomized by the TV commentator who reported, "Howard Marks says it's time to get out." As I said in September, there are two things I would never say (since they require far more certainty than I consider attainable): "get out" and "it's time." It's rare for the market pendulum to reach such an extreme that views can properly be black-or-white. Most markets are far too uncertain and nuanced to permit such unequivocal, sweeping statements.

In September I observed that the cautionary July memo hadn't said much with respect to what people actually should do about the markets, and I tried to remedy that. Now I want to provide a more complete discussion regarding today's markets, covering the pros as well as the cons.

Positives – Whereas in my last two memos I talked primarily about reasons to be cautious, I want to make it clear here that I do recognize the positives in the current situation. Most of them have to do with fundamentals – primarily the healthy macro-economic outlook and thus the potential for increasing EPS.

- **The U.S. economy is chugging along, and the recovery that started in 2009 has become one of the longest in history (103 months old at this point). The rest of the world's economies are joining in for that rare thing, worldwide growth. Most economies seem to be gaining rather than losing steam, and they don't appear likely to run out of it anytime soon.**
- Since the economic recovery hasn't been marked by excesses to the upside, when a recession eventually does occur, it doesn't have to be extreme. In short, no boom, no bust.
- One of the reasons for the sluggish recovery during the Obama administration was the low level of capital investment (a frequent site of excesses during recoveries). I think that was due to corporate concern over the president's seeming indifference to business and his tendency to regulate. No one wants to make long-term investments in an inhospitable environment for business. **In contrast, it's very clear that President Trump is committed to being a pro-business president and a deregulator.** This change has led to a rise in optimism, confidence and "animal spirits" among corporate executives, things that have great potential to be self-reinforcing. Thus, for example, in the first three quarters of 2017, capital spending rose at an annualized rate of 6.2%.
- The recent tax law will put money into the pockets of corporations that pay U.S. taxes by reducing their tax rate, and it will result in the repatriation of large amounts of foreign profits that

U.S. companies have been holding abroad. The results will generally be very positive for corporate profits, cash flows and perhaps capital investment (see below).

- The unemployment rate is down to 4.1%, nearly the lowest level in 60 years, meaning we're nearing "full employment" (albeit with an unusually low percentage of adults participating in the workforce). With so little employment slack remaining, it seems reasonable to think near-term GDP growth will translate into wage gains, and thus back into further increases in demand.
- Although low, today's prospective returns are described as being reasonable in the context of low interest rates.
- The low levels of inflation worldwide mean central bankers needn't rush to raise interest rates to restrain it. There's no obvious reason to predict hyperinflation.
- **Thus the near-term rise in interest rates – while probable – can be expected to be gradual and limited in scope.**
- Except in pockets, investor psychology can't be described as euphoric and imprudent (although it has been strengthening of late). **For years the markets have been "climbing a wall of worry," an old-fashioned phrase used to describe a healthy ascent that's occurring not because of euphoria and risk-obliviousness, but rather despite a catalog of perceived ills.**
- The known catalysts for a market downturn – recession, ballooning inflation, much-higher interest rates, major central bank missteps, a governmental breakdown in Washington, and war – can't be assigned probabilities that are more than modest.

Negatives – As opposed to the positives listed above, most of the negatives surround either (a) positive fundamental factors that have the potential to deteriorate or (b) the high prices being paid for those macro-positives, and the investor behavior creating those prices.

- While the outlook isn't dire, a number of subjects do represent genuine uncertainties and provide basis for concern: the possibility of slow long-term economic growth, the potential for rising interest rates and inflation, the impact of reversing stimulative monetary policy and the Fed switching to being a net seller of securities, the implications for employment as automation increases, the world's dependence on China's growth, and political and geopolitical tail risks. **As the markets have risen, talk of all these things seems to have gone quiet.**
- We know interest rates are likely to rise (creating competition for most asset classes and arguing for lower asset prices). We just don't know by how much.
- Some of the elements characterizing the macro-economic environment can be described as "long in the tooth" or "unusually elevated." For example, the current recovery is one of the longest ever; the GDP growth rate is at the top of the range for the last decade; and profit margins are well above average. Things like these can continue or even get better, but the odds are against it. It feels as if we may get through the next 18 months without a recession, but if we do, that'll make this the longest recovery since the 1850s. Certainly not impossible, but against the odds.
- **Most valuation parameters are either the richest ever** (Buffett ratio of stock market capitalization to GDP, price-to-sales ratio, the VIX, bond yields, private equity transaction multiples, real estate capitalization ratios) **or among the highest in history** (p/e ratios, Shiller cycle-adjusted p/e ratio). **In the past, levels like these were followed by downturns. Thus a decision to invest today has to rely on the belief that "it's different this time."**
- Prospective returns in the vast majority of asset classes are some of the lowest in history.
- **The need of investors to wring out good returns in this "low-return world" is causing them to engage in what I call pro-risk behavior.** They're paying high prices for assets and accepting risky and poorly structured propositions. In such a climate, it's hard for "prudent" investors to insist on traditional levels of safety. Investors who don't want to sign on for risk (that is, who "refuse to dance") can be constrained to the sidelines.

- As a result, we see a lot of the reaction that greeted my July memo: "the market's expensive, but I think it has further to go." How healthy can it be when investors think an asset or market is rich but they're holding anyway because they think it might go up some more? Fear of missing out (or "FOMO") is one of the more powerful reasons for investor aggressiveness, and also one of the most dangerous.
- Market behavior implies a level of equanimity on investors' part that could prove unrealistic (and thus subject to reversal). For example, 2017 was the first year in history in which the S&P 500 didn't decline from high to low by more than 3% at least once. Likewise, in a six-month period late in the year, the VIX (an indicator of the level of volatility implied by investors' pricing of S&P 500 options) closed below a reading of ten more than 40 days; never before had it done so more than six times in a six-month period (*The New York Times*, January 14).
- **It appears many investment decisions are being made today on the basis of relative return, the unacceptability of the returns on cash and Treasurys, the belief that the overpriced market may have further to go, and FOMO. That is, they're not being based on absolute returns or the fairness of price relative to intrinsic value.** Thus, as my colleague Julio Herrera said the other day, "valuation is a lost art; today it's all about momentum."
- The potential catalysts for decline that we have to worry about most may be the unknown ones. And although I read recently that bull markets don't die of old age or collapse of their own weight, I think sometimes they do (a dollar for anyone who can identify the catalyst for the collapse of the bull market and tech bubble in 2000 – it's not easy).

The bottom line of the above is that some people are excited about the fundamentals, and others are wary of asset prices. Both positions have merit, but as is often the case, the hard part is figuring out which one to weight more heavily.

As I wrote in September, most people (and certainly the media) want definite answers: in or out? buy or sell? risk-on or risk-off? But it's rare for answers that simple to be correct. There's a wide range of possible stances that investors might adopt. At one end of the spectrum there's maximum aggressiveness (100% invested in high-beta, high-risk assets, or maybe more than 100% through the use of leverage), and at the other there's maximum defensiveness (100% cash, or perhaps being net short). Most investors are never either of those.

And I certainly wouldn't be either of them today; I'd be someplace in between. That's easy to say. But where? Closer to the bullish end of the spectrum or the bearish end? Or balancing the two equally? **My answer today, as readers know, is that I would favor the defensive or cautious part of the spectrum.** In my view, the macro uncertainties, high valuations and risky investor behavior rule out aggressiveness and render defensiveness more sensible.

For one thing, I'm convinced the easy money has been made. For example, the S&P 500 has roughly quadrupled, including income, from its low in 2009. It was certainly easier for the p/e ratio to go from the low teens in 2011-12 to 25 today than it would be for it to double again from here. Thus the one thing we can say for sure is that the current prospects for making money in U.S. equities aren't what they were half a dozen years ago. And if that's the case, isn't it appropriate to take less risk in equities than one took six years ago?

Prospective returns are well below normal for virtually every asset class. Thus I don't see a reason to be aggressive. Some investors may adopt an aggressive stance to be in the riskiest (and thus hopefully the highest-returning) assets; to squeeze out the last drop of return as the markets continue to rise (under the assumption they'll be able to get out at the top, something that's present in every strongly rising market); or to achieve a high return in this low-return world. I don't view any of those as good ideas.

For years my description of the factors characterizing the markets has been essentially unchanged:

- a large number of big-picture uncertainties,
- sub-par prospective returns,
- above average valuations, and
- pro-risk investor behavior.

For as long as I have been discussing this view, no one has ever taken issue with any of these observations. Do you? That's the key question. And if not, what will you do about it?

You could have made the above four points a year ago, and two years ago, and three years ago, etc. And in general I did. Thus it was possible to argue for raising some cash at a variety of times over the last few years. However, going meaningfully to cash would have been a big mistake – certainly based on how markets performed, but also on the merits – and I think it still would be wrong today.

When I came up with the mantra that has governed at Oaktree over the last several years – "move forward, but with caution" – I described my position as follows:

- the outlook is not so bad, and prices are not so high, that it's time for maximum defensiveness (and if you turn to maximum defense today, your return will be near zero, something most people can't stomach), but
- the outlook is not so good, and prices are not so low, that it's right to be aggressive. In fact, the only thing I was sure of was that there was no place for aggressiveness.

So I didn't say, "Get out now," and I still wouldn't. But I think this continues to be a time to incorporate a good helping of defensiveness in portfolio management. Being fully invested in a cautious portfolio has been an appropriate stance over the last few years. It gave Oaktree performance that in general was respectable or better. **Aggressiveness would have produced higher returns, of course, but I don't think it could have been justified a priori.** (Is an incorrect decision one that didn't work out well, or one that was wrong at the time it was made? I insist it's the latter, as you know.)

And today? What has changed? To the four descriptors of the investment environment listed above, I would add three more:

- the economy is strengthening, not slowing, and Washington is supporting its progress,
- prices are even higher and valuation metrics have moved up,
- and, as I said, the easy money has been made.

Thus the current environment is still mixed – better fundamentally and worse price-wise. The positive near-term economic outlook, lowness of interest rates, need of most investors for return and moderate psychology all seem to suggest it would be a mistake to get out. On the other hand, the extremely high asset prices, macro-fragility and risky behavior going on all around us argue for considerable caution.

At times when the economy does well, risk doesn't rear its head, risk-takers prosper and the returns on low-risk alternatives are unattractive, investors tend to drop their prudence and conclude that high prices aren't a problem in and of themselves. This usually turns out to be a mistake, but it can take years.

For authority, I'll cite a passage that seconds that view:

> The market seems extremely comfortable with the proposition that as long as 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. . . .
>
> 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.

I wrote that in 1997, in a clients-only memo entitled "Are You an Investor or a Speculator?" I was cautionary then, like I am now. And it took almost three years for that to turn out to be correct. That doesn't mean it wasn't correct when it was written . . . just early.

Today there's beginning to be talk of a possible late-bull-market melt-up, making investors more money but perhaps fulfilling the requirements for a full-fledged bubble. (This may be part of the usual pattern of capitulation that occurs when those who haven't fully participated lose the will to keep abstaining after years of market gains.) The basic themes supporting the "melt-up" theory include (a) the existence of the fundamental positives listed above and (b) the arrival of euphoric psychology, which has been absent to date.

For me the key points regarding the general market outlook are as follows:

- The absence of widespread euphoria certainly is an important flaw in any near-term bearish view.
- Thus there's no reason for confidence in the existence of a soon-to-burst bubble.
- Investor psychology continues to grow more confident, however.
- Asset prices are already unusually high.
- Future events remain unpredictable, but today's high prices mean the odds are against a significant long-term upward move from here.
- No one can say what's going to happen in the short term.

Asset prices and valuation metrics are certainly worrisome, but psychology and its implications – as well as timing – are unpredictable. I think that's about all we can know.

Thus Oaktree will continue to invest on the basis of value and its relationship to price, and to refrain from trying to time markets based on predictions regarding economies, markets or psychology. The "melt-up" school says securities that already are highly priced may become more so. We'd never bet on whether they will or won't.

Our post-2011 mantra remains in force: we're investing when we find reasonable propositions, albeit with caution. We're investing, and with the exception of the distressed debt fund specifically raised to await an upsurge in opportunities, we aren't intentionally uninvested. If we find things with decent return prospects, structure and risk, we don't pass them by because we think they'll be cheaper a year from now. And we're making our views clear to clients so that, especially in our open-end strategies, they can make their own choice between aggressiveness and defensiveness. We would be happy to continue this discussion with clients off-line.

Reactions to the New Tax Law

The Republicans in Congress have passed and the president has signed a bill they hailed as "sweeping tax reform." It's worthy of comment. Everything going on in Washington is more politicized and less bipartisan than ever, but I'll attempt here to remain objective and not partisan while making what I think are the important observations.

First, with respect to the taxation of individuals, it's not much of a reform. It doesn't fundamentally change what income is taxed, how it is taxed, or the structure of the tax process. It reduces or eliminates some write-offs or loopholes, but not a great many. And I doubt it shortens the tax code.

I think what matters most is that it's primarily a tax cut for the majority of Americans, and tax cuts are stimulative. As I said before, the current U.S. economic recovery is one of the longest in history. The economy is doing well; it seems to be gaining strength; and it feels like the recovery can go on longer. With the unemployment rate nearing full employment, GDP growth may well go into a more dynamic period. So why stimulate?

- **It doesn't make sense to try to artificially prolong an already-long recovery.** Economies go up and down, and growth rates rise and fall. Governments (and central banks) should accept this rather than attempt to bring about rapid growth forever, which increases the risk of overheating. In the last twenty years we've had painful first-hand experience with the results of efforts to prevent the economy from slowing. GDP growth can be enhanced temporarily through a shot of fiscal adrenaline (like a tax cut), but that can't raise it permanently.
- **And doesn't it seem odd that the government is implementing a stimulative tax cut just as the Fed is raising interest rates and reversing its purchases of securities?** The Fed is concerned that a continuation and possible strengthening of the recovery will cause inflation to accelerate; thus it's acting to "remove the punchbowl." That makes sense. Why is the government taking fiscal actions in the opposite direction?
- The unanimous willingness of former "deficit hawks" to pass a bill that adds more than $1 trillion to deficits and debt is indicative of what I've seen described as "ideological pliability." Those who voted for it must have concluded that giving out goodies garners the most votes. **That bodes ill for fiscal discipline in the future.**

The centerpiece of the tax law is the reduction of the stated tax rate on corporate profits from 35% to 21%. What are its merits?

- Our corporate tax rate shouldn't be higher than the rates in other countries, as it has been to date. A higher rate gives companies an incentive to increase capacity abroad rather than in the U.S.; encourages U.S. companies to merge into foreign companies or relocate overseas; and gives foreign companies superior profitability.
- Lower rates will be good for our companies, and now our tax rate on corporate profits is one of the lowest in the developed world. Those of us who attribute much of the U.S.'s leading position in the world to capitalism think that's a good idea. I'm a strong believer that, within limits, "What's good for General Motors is good for America."
- Because of our previous corporate tax system, U.S. companies have $2.8 trillion of cash from foreign profits stranded overseas. Now that will be brought back at tax rates as low as 8%.
- **There's every reason to believe the rate cut and repatriation will put money in corporate coffers, enhance credit ratings, fatten dividend payments and finance stock buybacks.**
- But none of the above was the basis on which the corporate tax cut was sold to the public. Instead, it was billed as a job-creator. With unemployment already below average, many CEOs

tell me they're hamstrung by a scarcity of qualified workers. So who will fill the new jobs if corporations expand in the U.S.? And if workers aren't available, will new plants (and jobs) really be created?

- In the last days of the effort to pass the tax bill, I heard a talk-show guest say corporations and their owners would share its benefits with employees and consumers. We've seen a number of companies give raises or bonuses following the enactment of the tax law, but I doubt it was done out of generosity. Corporations may increase compensation if needed to attract, retain and motivate workers, and they may cut prices for competitive reasons, but the motivation will be to maximize profits – as always. I doubt the tax law will fundamentally alter their behavior.

So call it a gift to the corporate sector if you want, but I think it's unlikely to be much of a job-creator or long-term boon for the American middle class.

There will be pluses from the law, and there will be minuses. For me, the bottom line was captured best in a January 11 speech by William Dudley, the long-term and highly respected president of the New York Fed:

> While the recently passed Tax Cuts and Jobs Act of 2017 likely will provide additional support to growth over the near term, it will come at a cost. After all, there is no such thing as a free lunch. The legislation will increase the nation's longer-term fiscal burden, which is already facing other pressures, such as higher debt service costs and entitlement spending as the baby-boom generation retires. While this does not seem to be a great concern to market participants today, the current fiscal path is unsustainable. In the long run, ignoring the budget math risks driving up longer-term interest rates, crowding out private sector investment and diminishing the country's creditworthiness. These dynamics could counteract any favorable direct effects the tax package might have on capital spending and potential output.

Of all the possibilities, I find myself agreeing with Dudley's take on the likely consequences. **All else equal, the tax law is likely to result over time in higher deficits, higher national debt, higher economic growth, higher inflation, higher interest rates, higher federal debt service requirements, and thus still-higher deficits and debt. These things tend to go together, and together they constitute the fiscal path Dudley describes as unsustainable. The outlook was troubling before; the tax cuts will make it worse.**

The reward from the tax law is pretty clear: it's likely that in the short run the economy will strengthen, corporate profits will increase and take-home pay will rise for most Americans. But the long-term benefits are less certain, and meaningful hidden risks exist.

*   *   *

Next I want to spend some time on SALT. It wasn't long ago that most of us thought of this as the acronym for "strategic arms-limitation talks," but all of a sudden (in just the last few months, as far as I know), it has come to stand instead for "state and local taxes."

People who live in states with low or no income taxes may not have paid particular attention to the aspects of the new law relating to SALT, but it's a big topic in New York, where I live, and very much worth discussing. Up until now, to limit the impact of double taxation, itemizers have been able to deduct all state and local taxes paid from the income that was taxed at the federal level, the principle being that one should pay federal income tax only on what's left after state and local taxes have taken their cut (including income, property and sales taxes).

The proposed House bill eliminated this deduction completely, but the final law permitted deductibility up to $10,000. This avoided harming people with incomes below $100,000 or so, but those who earn more will feel it directly.

To simplify my calculations, I'm going to ignore tax rates on lower-bracket income, as well as the effect of exclusions and credits, and talk about the impact of this change on the higher earner's marginal dollar of income. I'm also going to round the figures and ignore Social Security and Medicare taxes.

- Before the new tax law, a top-bracket earner in New York City, for example, took home about $53 from $100 of marginal earnings (after federal income tax at 40% and state/city income taxes at 12%, less the benefit from recouping 40% of that 12% on the federal return because of its deductibility).
- Under the new law, take-home pay from $100 of incremental earnings will be about $51 (after federal tax at 37% and state/city tax at 12%).

Thus take-home pay per incremental dollar of earnings will decline by about 4%. The impact under the House bill would have been worse, but it was eased by a reduction from 39.3% to 37.0% of the tax rate applied to top earners. Still, 4% of take-home pay is a painful loss for most people.

Is the elimination of SALT deductibility unfair? The debate is complex, and like many things it depends on your point of view.

- On one hand, some states choose to give their citizens a lot of services (or have populations that require a lot of services, which has the same effect), and to pay for those services, they impose high income taxes. **Why, some say, should the federal government (and through it, residents of the low-tax and no-tax states) subsidize the high-tax states by absorbing some of their residents' tax burden?**
- On the other hand, according to estimates from *WalletHub*, the residents in fourteen "donor states" pay more to the federal government than they get back. They generally include states with high per capita incomes, such as New York, California, New Jersey and Illinois, and exclude states with the most people depending on federal largesse for their incomes. **Thus high-tax, high-business states subsidize the rest.**

One thing is not debatable: high-tax states are hurt in the absolute by this tax law, and hurt very much relative to low- and no-tax states. Because the deductibility of state and local income taxes is limited to $10,000, the impact will fall primarily on people in states with higher per capita incomes. There's a parallel treatment of property taxes, with deductibility also capped at $10,000. (The $10,000 is an aggregate limit for any combination of income, property and sales taxes.) And, relatedly, the law lowers the limit on the size of the mortgage on which interest is deductible. Not surprisingly, high incomes are correlated with high property values (and large mortgages), so people in some states are likely to be hit by all these limitations, and people in other states by none of them.

Is it a coincidence that most of the negative effect falls on states that are primarily Democratic or "blue"? Did President Trump mind reducing upper-bracket take-home pay in states that gave Hillary Clinton overwhelming pluralities a year ago? No one can say for sure, but there's no doubt about where the impact falls. As conservative economist and CNBC commentator Larry Kudlow put it, "It's a blue-state tax."

What are the important conclusions?

- **The reduction in take-home pay increases the penalty for living in high-tax states**. (For example, in 2015, 34% of California taxpayers itemized deductions, and on average they deducted $18,500 of state income tax. On average those taxpayers will lose an $8,500 deduction and thus pay roughly $3,000 more in federal income tax.)
- **Especially when added to high property taxes, this can give top-bracket earners a significant incentive to move to no-tax states such as Florida, Texas, Nevada and Washington.** As I wrote in "Economic Reality" in May 2016, states can raise their income tax rates (and the loss of federal deductibility is the equivalent of an increase in tax rates), but they can't prevent taxpayers from moving away.
- It's true the top federal income tax rate was reduced in the final law, perhaps halving the pain on taxpayers in high-tax states. But residents of no-tax states also get the tax rate reduction without having lost any deductions. I estimate for someone with a given large income, marginal take-home pay will be about 20% higher in a no-tax state than it is in New York, and that's a lot.
- **The bottom line is that the incentives for high earners to move in order to avoid SALT, always substantial, have increased.** I expect this to have a strong impact on the economies of the high-tax states. What CEO will move his company to New York or California in the future? Won't future company relocations and formations tend to favor the low-tax and no-tax states?
- I know a Republican congressman from New York who voted in favor of the tax bill. How could he? Won't his constituents turn against him and vote him out? He may figure that since he represents a low-income district, his voters won't be hurt by the loss of SALT deductibility. And that may be true as far as direct effects go. But the second-order consequences could easily see employers move away, taking their companies and the jobs of the congressman's constituents with them. **High-income people may move to chase lower state income tax rates, but folks with low incomes generally are much less able to do so.**
- The other day a friend told me the top 1% of New York taxpayers pay 50% of the state income taxes. **If and when their emigration accelerates, states like New York may get into a negative spiral**: a few big earners leave; the state has to raise tax rates to make up for the lost revenues; that increases the differential and causes more big earners to leave; which requires further tax-rate hikes, and so forth. High-tax cities and states may be greatly affected. New York City residents may feel there are attractions that justify the high rates, but neighboring "bedroom communities" lacking those attractions may be affected even more.

For me the bottom line on the new tax law is as follows:

- Our tax system is not fundamentally reformed. Such changes will be feasible only in the unlikely event that bipartisan cooperation returns to Washington.
- The net income of corporations that pay U.S. taxes will be enhanced, but the impact of the corporate tax reduction on other segments of the economy will be limited.
- The outlook is enhanced for no-tax and low-tax states and impaired for high-tax states.
- Overall, the tax law is likely a short-term positive and a long-term negative in a variety of ways.

*　　*　　*

The forthcoming book I mentioned earlier, due out in October, is about cycles. Why do cycles occur? Why doesn't the U.S. economy just grow at the average rate of 2-3% every year? And since the average return on the S&P 500 is in the range of 9-11%, why isn't the return between 9% and 11% every year (and, in fact, why does the yearly return fall between 9% and 11% so infrequently)?

The simple explanation is that because of the involvement of people, economies and markets – as well as other cyclical phenomena – tend first to overshoot in one direction (and given how people are wired, usually to the upside) and then they are bound to correct in the opposite direction.

I think that description is highly relevant to the two topics discussed above.

- When markets do too well for a while – that is, when equity returns far exceed the growth rate of companies' profits, and when bonds return more than their promised yield to maturity – it usually means they've become overpriced and will correct sooner or later.
- And when an economy expands faster than the potential growth rate determined by its population growth and increases in productivity – usually because companies or consumers borrow, invest or spend to excess – it's likely to contract eventually. This happens either because the excesses are unsustainable in and of themselves or because central bankers take steps to cool things off in order to avert hyperinflation.

That's the common thread here: markets that may have been doing too well, and an economy that may be in the process of being overstimulated. Both feel good right now, but each has potential negative consequences.

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I've been able to devote four pages to the new tax law primarily because so little has changed in the markets. Investors are still pursuing high returns in a low-return world. This entails a decline in risk aversion and produces risky behavior, rising asset prices, diminished prospective returns and increased risk. **It's impossible to say the negatives will win the tug-of-war anytime soon, but that doesn't mean caution should be discarded . . . especially now.**

January 23, 2018

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Memo to: Oaktree Clients

From: Howard Marks

Re: Investing Without People

Over the last twelve months I've devoted three memos to discussing macro developments, market outlook, and recommendations for investor behavior. These are important topics, but usually not the ones that interest me most; I prefer to discuss things that are likely to affect the functioning of markets for years to come. Since little in the environment has changed from what I described in those three memos, I feel I now have the liberty to turn to some bigger-picture issues.

This memo covers three ways in which securities markets seem to be moving toward reducing the role of people: (a) index investing and other forms of passive investing, (b) quantitative and algorithmic investing, and (c) artificial intelligence and machine learning.

Before diving in, I want to state loud and clear that I don't claim to be an expert on these subjects. I've watched the first for decades; I've recently learned a little about the second; and I'm trying to catch up regarding the third. On the other hand, since many of the "experts" in these fields are involved in them, I think they may be biased favorably toward them as potential successors to traditional active investing. What follow are just my opinions; as always you should make of them what you wish.

<u>Passive Investing and ETFs</u>

I've told this story many times, but I want to repeat it here to lay a foundation for what follows. I arrived at the University of Chicago Graduate School of Business (not yet the Booth School) just over 50 years ago, in September 1967. The "Chicago school" of finance and investment theory – largely developed there in the early '60s – had just begun to be taught. It was methodically constructed on theoretical underpinnings, as well as on a healthy dose of skepticism regarding what investors had been doing previously.

One of the major foundational components was the "Efficient Market Hypothesis" and its conclusion that "you can't beat the market." First there was the logical argument: it seemed obvious that collectively all investors have to do average before fees and expenses, and thus below average after. And then there was the empirical evidence that for decades most mutual funds had performed behind stock indices like the Standard & Poor's 500.

My professors' response in the late 1960s was simple, albeit hypothetical and fanciful: why not just buy shares in every company in an index? Doing so would allow investors to avoid the mistakes most people made, as well as the vast majority of the fees and costs associated with their efforts. And at least they would be assured of performing in line with the index, not behind it. As far as I know, no one invested that way at the time and there were no publicly available vehicles for doing so: no "index funds" and no "passive investing." I don't think the terms even existed. But the logic was clear and convincing, per the following citation from Wikipedia (with apologies to Richard Masson, my conscience regarding sources, for relying on it):

> In 1973, Burton Malkiel wrote *A Random Walk Down Wall Street*, which presented academic findings for the lay public. It was becoming well known in the lay financial press that most mutual funds were not beating the market indices. Malkiel wrote:
>
> > What we need is a no-load, minimum management-fee mutual fund that simply buys the hundreds of stocks making up the broad stock-market averages and does no trading from security to security in an attempt to catch the winners. **Whenever below-average performance on the part of any mutual fund is noticed, fund spokesmen are quick to point out "You can't buy the averages." It's time the public could.**
> >
> > . . . there is no greater service [the New York Stock Exchange] could provide than to sponsor such a fund and run it on a nonprofit basis. . . . Such a fund is much needed, and if the New York Stock Exchange (which, incidentally has considered such a fund) is unwilling to do it, I hope some other institution will. (Emphasis added)

The first index fund appeared around that time. Again according to Wikipedia, the registration statement for the Qualidex Fund, designed to track the Dow Jones Industrial Average, became effective in 1972. I have no reason to believe it attracted many investors.

But then Jack Bogle formed the Vanguard Group in 1974, and Vanguard's First Index Investment Trust went operational on the last day of 1975.

> At the time, it was heavily derided by competitors as being "un-American" and the fund itself was seen as "Bogle's folly." Fidelity Investments Chairman Edward Johnson was quoted as saying that he "[couldn't] believe that the great mass of investors are going to be satisfied with receiving just average returns." Bogle's fund was later renamed the Vanguard 500 Index Fund, which tracks the Standard & Poor's 500 Index. It started with comparatively meager assets of $11 million but crossed the $100 billion milestone in November 1999. (Wikipedia)

The merits of index investing are obvious: vastly reduced management fees, minimal trading and related market impact and expenses, and the avoidance of human error. **Thus index investing is a "can't lose" strategy: you can't fail to keep up with the index. Of course it's also a "can't win" strategy, since you also can't beat the index (the two tend to go together).**

Index or passive investing got off to a relatively slow start. In the early years, I feel it was treated as a bit of an oddity or sideline: perhaps a candidate to take the place of one or two of an institutional investor's active managers. As they did with many potential alternatives to traditional stock and bond investing – such as emerging market stocks, private equity, venture capital, high yield bonds, distressed debt, timber and precious metals – some institutions put a smattering of capital into index funds, but rarely enough to meaningfully alter the performance of their overall portfolios. Few institutions if any made passive investing a substantial part of their portfolios: thus it added a little spice but wasn't a main dish.

The empirical evidence of assets continuing to flow to passive management suggests that many active managers are still falling short of the indices. There have been lots of years in the last dozen in which the shortfall has been pronounced, and I'm not aware of many that were the reverse. As a result, the trend toward passive investing has steadily gained momentum (e.g., the Vanguard 500 Index Fund now stands at $410 billion). According to data from Morningstar, roughly similar amounts went into active and passive equity mutual funds from 2005 through 2011, but the flows into passive funds accelerated in 2012, while the inflows to active funds began to decline and, in 2015, turned into outflows. According to the *Los Angeles Times*, April 9, 2017:

> Conventional U.S. stock mutual funds that invest passively now hold $1.9 trillion in assets, triple what they had in 2007. Add in the $1.7 trillion in U.S. equity exchange-traded funds, another type of index portfolio, and the total in passive funds accounts for 42% of all U.S. stock fund assets — up dramatically from 24% in 2010 and just 12% in 2000.

These figures apply mostly to "retail" investments, leaving out institutional portfolios where passive investing also has grown dramatically. Rather than being an exotic add-on with a few percent of a portfolio's assets, passive investing is now mainstream among institutions, perhaps often accounting for 20% or so of total assets.

Given the *L.A. Times* quote above, I want now to introduce ETFs, or exchange-traded funds. In the 1990s, money managers came up with a new way to offer participation in the markets, in competition with index mutual funds. Whereas investors can only invest in or redeem from mutual funds at the close of trading each day, when the daily closing net asset value (or NAV) is calculated, ETFs can be bought or sold like company shares anytime exchanges are open. The ability to transact much more freely has attracted a lot of attention to ETFs. And while index ETFs gave this new field its start and still represent the vast bulk of ETFs, there are many other types these days.

In the late 20th century, "index investing" and "passive investing" were synonymous: vehicles designed to passively emulate market indices. But now there's a difference. Today this is called index investing. Passive investing has grown to include not just index funds and index ETFs, but also "smart-beta" ETFs that invest according to portfolio construction rules. Think of them as actively designed, rules-based vehicles. Once the rules are set, they're followed without discretion. As I wrote a year ago:

> [To grow their businesses], ETF sponsors have been turning to "smarter," not-exactly-passive vehicles. Thus ETFs have been organized to meet (or create) demand for funds in specialized areas such as various stock categories (value or growth), stock characteristics (low volatility or high quality), types of companies, or geographies. There are ETFs for people who want growth, value, high quality, low volatility and momentum. Going to the extreme, investors can now choose from funds that invest passively in companies that have gender-diverse senior management, practice "biblically responsible investing," or focus on medical marijuana, solutions to obesity, serving millennials, and whiskey and spirits.

> But what does "passive" mean when a vehicle's focus is defined so narrowly? **Each deviation from the broad indices introduces definitional issues and non-passive, discretionary decisions.** Passive funds that emphasize stocks reflecting specific factors are called "smart-beta funds," but who can say the people setting their selection rules are any smarter than the active managers who are so disrespected these days? Steven Bregman of Horizon Kinetics calls this "semantic investing," meaning stocks are chosen on the basis of labels, not quantitative analysis. [For example, he points out that because it's so big and liquid, Exxon Mobil is included in both growth and value ETFs.] There are no absolute standards for which stocks represent many of the characteristics listed above. ("There They Go Again . . . Again" July 2017)

According to Wikipedia, "as of January 2014, there were over 1,500 ETFs traded in the U.S. . . ." That compares with 3,599 stocks in the Wilshire 5000 Total Market Index (per *Barron's*). To me, the number and variety of ETFs serves as a reminder of the financial industry's customary eagerness to accommodate people's desire in good times to "get action" in the markets. And how else should we view the levered ETFs that have been designed to appreciate or depreciate by a multiple of what an index does?

That's the background. Now I'm going to turn to the implications of passive investing and its increasing popularity. **The first question is, "Is passive investing wise?"**

In passive investing, no one at the fund is studying companies, assessing their potential, or thinking about what stock price is justified. And no one's making active decisions as to whether particular stocks should be included in a portfolio and, if so, how they should be weighted. They're just emulating the index.

Is it a good idea to invest with absolutely no regard for company fundamentals, security prices or portfolio weightings? Certainly not. But passive investing dispenses with this concern by counting on active investors to perform those functions. The key lies in remembering why it is that the Efficient Market Hypothesis says active management can't work, and thus why it expects everyone (good or bad luck aside) to just end up with a return that's fair for the risk borne . . . no more and no less. I touched on this in "There They Go Again . . . Again," which will be the source for the next three citations:

> **. . . the wisdom of passive investing stems from the belief that the efforts of active investors cause assets to be fairly priced – that's why there are no bargains to find.**

And where do the weightings of the stocks in indices come from? From the prices assigned to stocks by active investors. **In short, in the world view that gave rise to index and passive investing, active investors do the heavy lifting of security analysis and pricing, and passive investors freeload by holding portfolios determined entirely by the active investors' decisions.** There's no such thing as a capitalization weighting to emulate in the absence of active investors' efforts.

The irony is that it's active investors – so derided by the passive investing crowd – who set the prices that index investors pay for stocks and bonds, and thus who establish the market

capitalizations that determine the index weightings of securities that index funds emulate. If active investors are so devoid of insight, does it really make sense for passive investors to follow their dictates?

And what happens if active investors quit doing that job? **Thus the second question is, "What are the implications of passive investing for active investing?"** If widespread active investing makes it impossible for active investing to succeed (by making markets too efficient and security prices too fair, per the Efficient Market Hypothesis), will the increasing prevalence of passive investing make active investing once again potentially profitable?

> **. . . what happens when the majority of equity investment comes to be managed passively?** Then prices will be freer to diverge from "fair," and bargains (and over-pricings) should become more commonplace. This won't assure success for active managers, but certainly it will satisfy a necessary condition for their efforts to be effective.

How much of the investing that takes place has to be passive for price discovery to be insufficient to keep prices aligned with fair values? No one knows the answer to that. Right now about 40% of all equity mutual fund capital is invested passively, and the figure may be moving in that direction among institutions. That's probably not enough; most money is still managed actively, meaning a lot of price discovery is still taking place. Certainly 100% passive investing would suffice: **can you picture a world in which nobody's studying companies or assessing their stocks' fair value? I'd gladly be the only investor working in that world.** But where between 40% and 100% will prices begin to diverge enough from intrinsic values for active investing to be worthwhile? That's the question. I don't know, but we may find out . . . to the benefit of active investing.

The third key question is: **"Does passive and index investing distort stock prices?"** This is an interesting question, answerable on several levels.

The first level concerns the relative prices of the stocks in a capitalization-weighted index. People often ask whether inflows of capital into index funds cause the prices of the heaviest-weighted stocks in the index to rise relative to the rest. I think the answer is "no." Suppose the market capitalizations of the stocks in a given index total \$1 trillion. Suppose further that the capitalization of one popular stock in the index – perhaps one of the FAANGs – is \$80 billion (8% of the total) and that of a smaller, less-adored one is \$10 billion (1%). That means for every \$100,000 in an index fund, \$8,000 is in the former stock and \$1,000 is in the latter. It further means that for every additional \$100 that's invested in the index, \$8 will go into the former and \$1 into the latter. Thus the buying in the two stocks occasioned by inflows shouldn't alter their relative pricing, since it represents the same percentage of their respective capitalizations.

But that's not the end of the story. The second level of analysis concerns stocks that are part of the indices versus those that aren't. Clearly with passive investing on the rise, more capital will flow into index constituents than into other stocks, and capital may flow out of the stocks that aren't in indices in order to flow into those that are. It seems obvious that this can cause the stocks in the indices to appreciate relative to non-index stocks for reasons other than fundamental ones.

The third level concerns stocks in smart-beta funds. The more a stock is held in non-index passive vehicles receiving inflows (*ceteris paribus*, or everything else being equal), the more likely it is to appreciate relative to one that's not. And stocks like Amazon that are held in a large number of smart-beta funds of a variety of types are likely to appreciate relative to stocks that are held in none or just a few.

What all the above means is that for a stock to be added to index or smart-beta funds is an artificial form of increased popularity, and it's relative popularity that determines the relative prices of stocks in the short run.

> The large positions occupied by the top recent performers – with their swollen market caps – mean that as ETFs attract capital, they have to buy large amounts of these stocks, further fueling their rise. **Thus, in the current up-cycle, over-weighted, liquid, large-cap stocks have benefitted from forced buying on the part of passive vehicles, which don't have the option to refrain from buying a stock just because its overpriced.**
>
> **Like the tech stocks in 2000, this seeming perpetual-motion machine is unlikely to work forever.** If funds ever flow out of equities and thus ETFs, what has been disproportionately bought will have to be disproportionately sold. **It's not clear where index funds and ETFs will find buyers for their over-weighted, highly appreciated holdings if they have to sell in a crunch. In this way, appreciation that was driven by passive buying is likely to eventually turn out to be rotational, not perpetual.**

The vast growth of ETFs and their popularity has coincided with the market rally that began roughly nine years ago. Thus we haven't had a meaningful chance to see how they function on the downside. Might the inclusion and overweighting in ETFs of market darlings – a source of demand that may have driven up their prices – be a source of stronger-than-average selling pressure on the darlings during a retreat? Might it push down their prices more and cause investors to turn increasingly against them and against the ETFs that hold them? **We won't know until it happens, but it's not hard to imagine the popularity that fueled the growth of ETFs in good times working to their disadvantage in bad times.**

Question number four: **"Can the process of investing in indices be improved relative to simply buying the stocks in proportion to their market capitalizations, as the indices are constituted?"** For many years my California-based friend Rob Arnott of Research Affiliates has argued for passive investing on the basis of fundamentally based indices as opposed to market-weighted indices. Rob is one of the real thinkers in our field, and I won't try to recount his entire argument or do it justice.

Suffice it to say, however, that a given company with a given amount of earnings will have a greater market capitalization the higher its price/earnings ratio is . . . that is, the more it's loved. **Thus, everything else being equal (there's that *ceteris paribus* again), the heavier-weighted stocks in an index are likely to be the more highly priced ones.** Do you want to put more of your index-investing money into the more expensive stocks or the ones that are cheaper? I'd rather do the latter. Thus it makes sense to invest in the index stocks in proportion to something like their earnings, not their market caps.

Question number five: **"Is there anything innately wrong with ETFs and their popularity?"** ETFs are just another vehicle for buying stocks and bonds. They're neither good nor bad *per se*. But there is a way in which I worry about ETFs' impact, and it has to do with the expectations of the people who invest in them.

My thinking goes back to the reason ETFs gained popularity in the first place: the ability to buy or sell them anytime the market is open. I'd bet a lot of the people who make use of ETFs do so for the simple reason that they think they're "more liquid." There are a couple of problems with this.

First, as I wrote in "Liquidity" (March 2015), the fact that something is able to be sold legally, or the fact that there's a market for it, can be very different from the fact that it can always be sold at a price that's intrinsically fair or close to the last price at which it sold. If bad news or a downturn in investor psychology causes the market to drop, invariably there'll be a price at which an ETF holder can sell, but it may not be a "good execution." **The price received may represent a discount from the value of the underlying assets, or it may be less than it would have been if the market were functioning on an even keel.**

If you withdraw from a mutual fund, you'll get the price at which the underlying stocks or bonds closed that day, the net asset value or NAV. But the price you get when you sell an ETF – like any security on an exchange – will only be what a buyer is willing to pay for it, and I suspect that in chaos, that price could be less than the NAV of the underlying securities. Mechanisms are in place that their designers say should prevent the ETF price from materially diverging from the underlying NAV. But we won't know if "should" is the same as "will" until the mechanisms are tested in a serious market break.

Some people may have invested in ETFs in the mistaken belief that they're inherently more liquid than their underlying assets. For example, high yield bond ETFs have been very popular, probably because it's far easier to buy an ETF than to assemble a portfolio of individual bonds. But what's the probability that in a crisis, a high yield bond ETF will prove more liquid than the underlying bonds (which themselves are likely to become quite illiquid)? The weakness lies in the assumption that a vehicle can provide more liquidity than is provided by its underlying assets. **There's nothing wrong with the fact that ETFs may prove illiquid. The problem will arise if the people who invested in them did so with the expectation of liquidity that isn't there when they need it.**

In March I noticed a Bloomberg story about the $900 million BTS Tactical Fixed Income Fund managed by Matt Pasts, which on February 9 went from "almost entirely in junk bonds" to fully in cash:

> [BTS] employs no credit analysts to study the fundamentals of bonds. Pasts is a market timer, trying to suss out whether the whole high-yield asset class is going to rise or fall in value. He watches trend and momentum measures, such as the moving average of the price of exchange-traded funds that track the junk bond market. When not in junk, BTS is either in Treasuries or cash.
>
> Trading completely in and out of the market is simple for BTS because the fund doesn't directly hold the bonds. Instead, it has the unusual strategy for a fund of

investing almost entirely via ETFs. In late January, before it sold, BTS had about 95% of its assets in the two largest junk-bonds ETFs.

Leaving aside the question of whether a manager can add value by predicting the short-run direction of a market – about which I would be highly skeptical – **I think one of these days, this investor may want to execute a trade that wouldn't be doable in the "real" high yield bond market, and he'll find that it can't be done via ETFs either.** In short, building a strategy around the assumption that ETFs can always be counted on to quickly get you into or out of an illiquid market at a fair price seems unrealistic to me. The truth on this will become clear when the tide goes out.

* * *

Passive/index investing got its start because of a view that the stock market would grind on as it always had, with active investors setting "proper" prices for securities. That would enable passive investors to participate in the markets – assembling portfolios that mimic the indices and "free-riding" on the work and price discovery performed by active investors – without picking up their share of the analytical tab.

But that misses the reality behind George Soros's Theory of Reflexivity: that the actions of market participants change the market. Nothing in a market always continues, independent and unchanged. A market is nothing more than the people in it and the decisions they make, and the behavior of those people shapes the market. When people invest more in certain stocks than others, the prices of those stocks rise in relative terms. And when everyone decides to refrain from performing the functions of analysis, price discovery and capital allocation, the appropriateness of market prices can go out the window (as a result of passive investing, just as it does in a mindless boom or bust). **The bottom line is that the wisdom of investing passively depends, ironically, on some people investing actively. When active investing is dismissed totally and all active efforts cease, passive investing will become imprudent and opportunities for superior returns from active investing will reemerge**. At least that's the way I see it.

<u>Quantitative Investing</u>

My next topic – which, as I said, I'm just learning about (and thus I write with some trepidation) – goes by names such as quantitative, algorithmic and systematic investing. In this memo I'll use the first of those. As I understand it, quantitative investing consists of establishing a set of rules (perhaps with help from a computer) and having a computer carry them out.

There are at least two principal forms of quantitative investing. The first might be called "systematic factor investing." The process goes like this:

- The manager conducts an examination of a period in history, which shows that superior returns were associated with certain "factors." Factors are attributes that characterize securities, such as value, quality, size and momentum. Perhaps in a given period the stocks that did best were characterized by strong value, high quality, large capitalizations and recent appreciation (or “momentum”). Thus the manager concludes that his portfolio should consist of stocks that rank high in those factors. (Of course those factors don’t always lead to above average returns; if things change, growth, low quality, smallness and recent under-performance might be associated with superior returns instead.)

- The manager instructs its computer to search for securities that offer the most of those factors for the money. Thus, for example, the computer might search for value based on measures including price/earnings ratio, enterprise value/EBITDA ratio, price/book ratio and price/free cash flow ratio, as well as industry-specific metrics such as the ratio of price to reserves for oil companies.
- Then the manager tells the computer in what proportion to weight the search criteria, and the computer proceeds systematically to populate the portfolio with securities that deliver the optimal mix of the factors.
- Finally, the computer is instructed to assess the attendant risk. The portfolio is optimized, constraining even the most attractive components in order to limit the representation of individual stocks and perhaps industries, as well as the risk introduced by likely correlations among the stocks. The portfolio is formulaically derived according to the rules, usually without human intervention.

The end product of this process is a portfolio that, according to the algorithm, will deliver the highest expected return with the least risk (under the assumption that the factors associated with superior returns in the past will continue to be so associated in the future, and that assets will be volatile and correlated as in the past).

The other main form of quantitative investing is “statistical arbitrage” or “stat arb.” For an example of stat arb, let’s assume an investor wants to buy 100,000 shares of XYZ, and the market for that stock is “one cent wide” at $20.00/20.01 (perhaps 5,000 shares are bid for at $20.00 and 8,000 shares are offered at $20.01). The broker takes the 8,000 shares offered at $20.01. The next offering is 6,000 shares at $20.02, and the broker takes those. Then a seller offers 5,000 shares at $20.03, and the broker takes those as well. This buying may move the market to $20.03/20.04.

A quant’s computer takes note of the fact that the market has moved up and stock has been bought at progressively higher prices.

- If other stocks haven’t moved in similar fashion, the computer concludes that these events are “idiosyncratic” – related to that one stock – rather than “systematic,” or present throughout the market.
- If that stock’s price has moved up idiosyncratically and there’s no news from the company to explain it, the computer concludes the price move took place because of investor buying, not fundamental developments.
- The computer considers the price move a short-term dislocation that resulted from the broker’s efforts to fill the investor’s order.
- It also decides on the basis of the trading to date, the current market, and the status of the order book that buying for that purpose is likely to continue to take place at prices above where the stock would be in the absence of that buying.
- Thus the computer decides the quant should “short” stock (sell stock the quant doesn’t own) to the buyer who’s elevating its price, on the assumption that the quant will be able to cover

later, when the buying has stopped and the price has receded. It might be possible to sell stock today at $20.03 or $20.04 that can be bought back at $20.00 or 20.01 in a few days.
- Thus the quant provides liquidity that otherwise wouldn't exist and is willing to carry positions overnight. In exchange the quant gets a couple pennies more for the stock he supplies than he'll have to pay to buy it back.

We might say that for the most part, the stat arb computer responds to disequilibria between the price of one stock and the prices of other stocks or the market as a whole, and it acts on the assumption that the relationships will revert to normal. The pennies made aren't a big deal (perhaps a 0.1% profit in the above example), and as Renaissance Technologies said in a statement to a Senate subcommittee in 2014 concerning its core Medallion fund, "The model developed by Renaissance . . . makes predictions that are profitable only slightly more often than not." But if you do it often enough and on enough leverage, stat arb can produce meaningful returns on equity.

This is like what Long-Term Capital Management did in the late 1990s, looking for statistical divergences that could be arbitraged. One of its executives described what it did as going around the world picking up nickels and dimes. But in 1998, LTCM's enormously levered portfolio encountered an improbably long period in which, rather than converging, the relationships diverged further. Mark-to-market losses caused Long-Term's lenders to require the posting of additional capital; unable to do so, the fund melted down; and securities industry leaders had to take on its portfolios. It turned out that LTCM had been picking up nickels and dimes in front of a steamroller, and the steamroller caught up with it.

Among the lessons learned in the LTCM experience were that (a) the opportunities for stat arb are limited in size, (b) the capital directed at it must likewise be limited, (c) the leverage employed must be reasonable in order for the investor to survive those periods when historic relationships and probabilities fail to hold, and (d) likewise, it's important to appropriately hedge out the market's overall directional risk.

*   *   *

Quantitative investors program their computers to emulate behavior that was profitable in the past or that is expected to be profitable in the future. In other words, they set rules or formulas for their computers to live by. The key question is whether, in a competitive, dynamic and interconnected arena like investing, the route to profitability can be captured in a formula, and whether changes in the investment environment (perhaps caused by the very implementation of the formula) won't negate the formula's effectiveness.

Just the other day, I got an email from Rosalie J. Wolf, a former CIO and consultant to some of our clients' boards, asking which memo contained a quote she likes to use. It turned out to be from "Dare to be Great" (September 2006), and ironically it's extremely relevant to the question raised above:

> How can we achieve superior investment results? The answer is simple: not only am I unaware of any formula that alone will lead to above average investment

performance, but I'm convinced such a formula cannot exist. According to one of my favorite sources of inspiration, the late John Kenneth Galbraith:

> There is nothing reliable to be learned about making money. If there were, study would be intense and everyone with a positive IQ would be rich.

Of course there can't be a roadmap to investment success. First, the collective actions of those following the map would alter the landscape, rendering it ineffective. And second, everyone following it would achieve the same results, and people would still look longingly at the top quartile . . . the route to which would have to be found through other means.

Before going further, let me elaborate on my skepticism regarding the potential for a formula that alone will lead to above average investment performance.

First, while there are ways to invest that I think can't work, there also are exceptional people who succeed at them. I include here active trading, macro investing and quantitative investing. As for the last, Renaissance Technologies and Two Sigma enjoy excellent reputations for their performance. My mother used to say, "It's the exception that proves the rule." She meant, for example, the fact that only a tiny number of people can do something proves that most people can't. So while I wouldn't say my skepticism is always justified, I do think it's generally appropriate. By definition it doesn't make sense to think large numbers of people can arrive at formulas that produce exceptional performance.

Second, the key word is "alone." Any old formula cannot unlock the secret of investment success. **An exceptional formula, arrived at on the basis of exceptional intelligence and insight, conceivably can do the job, although maybe just for a limited time.**

It seems obvious that a formula's application and popularization eventually will bring an end to its effectiveness. Let's say (in an incredibly simplified example) your study of the market shows that small-company stocks have beaten the market over a given period, so you overweight them.

a) Since "beating the market," "out-appreciating" and "out-performing" often are just the flip side of "becoming relatively expensive," I doubt any group of stocks can outperform for long without becoming fully- or over-priced, and thus primed for underperformance.
b) And it seems equally clear that eventually others will detect the same "small-cap effect" and pile into it. In that case, small-cap investing will become widespread and – by definition – no longer a source of superiority.

To reiterate, George Soros's Theory of Reflexivity says the behavior of market participants alters the market. Thus no formula will be a winner forever. For me, that means the achievement of superior returns through quantitative investing requires the ability to constantly and correctly update the formula. **Since investing is dynamic, the rules relied on in quantitative investing have to be dynamic.**

According to Raj Mahajan of Goldman Sachs, my principal tutor on these matters, "The best models today will change exposures as the environment changes and as the dynamics of the factors change (e.g., as they become cheaper or more expensive). The rules have become increasingly complex, and they are able to 'learn' (that is, they are 'conditional' or 'contextual') in that they understand more of the environment." **Constant renewal – not "a formula alone" – seems to be a minimum requirement for any quants' long-term success.**

* * *

It seems to me that while the members of both fraternities might reject the comparison, quantitative investing has some things in common with smart-beta ETF investing:

- Both are rules-based, pursuing the attributes the managers want in their holdings.
- In both, once the rules are set, the humans (largely) take their hands off the wheel and leave implementation up to computers.

The main differences I see – and they are very substantial – are that:

- There's much more trading in quantitative investing. Since index funds and ETFs are "passive" and thus indifferent to company fundamentals and the attractiveness of security prices, they largely buy and hold. On the other hand, quantitative investors' computers constantly recheck their portfolios against the algorithms or rules.
- The quantitative process is much more . . . quantitative. As Steven Bregman said, smart-beta ETFs buy based on "semantics": on how securities are labeled (without any quantitative standards for membership in groups). Quantitative investors, on the other hand, do so based on quantitative assessment of securities' fundamentals and price.

In closing on the subject of quantitative investing, I want to mention a few issues related to timeframe (some of them suggested by my son Andrew).

- Most quantitative investing is a matter of taking advantage of standard patterns (the factors that have been correlated with outperformance) and normal relationships (like the usual ratio of one stock's price to another's or to the market).
- Quants invest on the basis of historic data regarding these things. But what will happen if patterns and relationships are different in the future from those of the past?
- Is it important that most quantitative investors have operated only in periods when interest rates were declining, inflation was low and volatility was low, and when the trends in these regards were fairly stable? **Will their approaches prove dynamic enough to adjust if rates, inflation and volatility rise or become more variable? And if they do rise or become more variable, what historic data will quants use in their rule-making?**
- Likewise, is it significant that there's limited history of investment performance in periods influenced by quants? **In other words, will increased quantitative investing influence the effectiveness of quantitative investing, and thus alter the requirements for success?**

We'll see, but certainly it can't be said that most quantitative investors are proven in these regards.

Artificial Intelligence and Machine Learning

Since I'm now well beyond the limits of my technological expertise, I'm going to rely on Wikipedia again to introduce a discussion of these next topics:

> Artificial intelligence is intelligence demonstrated by machines, in contrast to the natural intelligence displayed by humans and other animals. In computer science AI research is defined as the study of "intelligent agents": any device that perceives its environment and takes actions that maximize its chance of successfully achieving its goals. Colloquially, the term "artificial intelligence" is applied when a machine mimics "cognitive" functions that humans associate with other human minds, such as "learning" and "problem solving."
>
> . . . Capabilities generally classified as AI as of 2017 include successfully understanding human speech, competing at the highest level in strategic game systems (such as chess and Go), autonomous cars, intelligent routing in content delivery network and military simulations.
>
> . . . The traditional problems (or goals) of AI research include reasoning, knowledge representation, planning, learning, natural language processing, perception and the ability to move and manipulate objects.

In other words, artificial intelligence means the ability of machines to think. Quantitative investing consists of giving computers instructions to follow. But a computer with artificial intelligence can figure out what to do for itself. As *Investor's Business Daily* put it on May 10, "AI uses computer algorithms to replicate the human ability to learn and make predictions."

Bernard Marr goes on in *Forbes* (December 6, 2016) to make the distinction between artificial intelligence and machine learning:

> In short, the best answer is that Artificial Intelligence is the broader concept of machines being able to carry out tasks in a way that we would consider "smart."
>
> And Machine Learning is a current application of AI based around the idea that we should really just be able to give machines access to data and let them learn for themselves. . . .
>
> Two important breakthroughs led to the emergence of Machine Learning as the vehicle which is driving AI development forward with the speed it currently has.
>
> One of these was the realization – credited to Arthur Samuel in 1959 – that rather than teaching computers everything they need to know about the world and how to carry out tasks, it might be possible to teach them to learn for themselves.
>
> The second, more recently, was the emergence of the internet, and the huge increase in the amount of digital information being generated, stored, and made available for analysis.

> Once these innovations were in place, engineers realized that **rather than teaching computers and machines how to do everything, it would be far more efficient to code them to think like human beings, and then plug them into the internet to give them access to all of the information in the world.** (Emphasis added)

So, as this non-techie sees it, AI can enable machine learning whereby computers sift through huge amounts of data and discern the route to success. They don't have to be fed rules as in quantitative investing; **they figure out the rules for themselves.**

(One of the ways the best chess players become Grand Masters is by studying past chess matches, watching the moves that were made, and remembering what move was most successful in each situation, and the best response to that move. But there are obvious limits to the number of games a person can study and the number of moves that can be remembered. That's the thing: a powerful-enough computer can review every game that's ever been played, assess the consequences of every move, and decide on moves that will lead to success. Thus computers are beating Grand Masters these days, and no one's surprised anymore when they do.)

Machine learning is still in its infancy. It may be that AI and machine learning will someday permit computers to act as full participants in the markets, analyzing and reacting in real time to vast amounts of data with a level of judgment and insight equal to or better than many investors. But I doubt it will be anytime soon, and Soros's Theory of Reflexivity reminds us that all those computers are likely to affect the market environment in ways that make it harder for them to achieve success.

The Impact on Investing

It's only taken me until page fourteen to get to the issue that prompted me to start in on this memo: what these things imply for the future of our profession.

For me, the situation regarding index and passive investing is clear:

- Most people can't and don't beat the market, especially in markets that are more-efficient. On average, all portfolios' returns are average before taking costs into account.
- Active management introduces considerations such as management fees; commissions and market impact associated with trading; and the human error that often leads investors to buy and sell more at the wrong time than at the right time. These all have negative implications for net results.
- The only aspect of active management with potential to offset the above negatives is alpha, or personal skill. However, relatively few people have much of it.
- For this reason, large numbers of active managers fail to beat the market and justify their fees. **This isn't just my conclusion: if it weren't so, capital wouldn't be flowing from active funds to passive funds as it has been.**
- Regardless, for decades active managers have charged fees as if they earned them. Thus the profitability of many parts of the active investment management industry has been without reference to whether it added value for clients.

It's important to note that the trend toward passive investing hasn't occurred because the returns there have been great. It's because the results from active management have been poor, or at least not good enough to justify the fees charged.

Now clients have wised up, and unless something changes with regard to the above, the trend toward passive investing is going to continue. What could arrest it?

- More active managers could become capable of delivering alpha (but that's not likely).
- The markets could become easier to beat (that'll probably happen from time to time).
- Fees could come down so that they're competitive with passive investment fees (but in that case it's not clear how the active management infrastructure would be supported).

Unless there are flaws in the above reasoning, the trend toward passive investing is likely to continue. **At the very least, it reduces or eliminates management fees, trading costs, overtrading and human error: not a bad combination.**

Of course, there are active investors who outperform. Not most, and not half. **But there's a minority who do earn their fees, and they should continue to be in demand.**

*   *   *

Moving on to quantitative investing, it's particularly interesting to assess the future. The good news about quantitative investing is that it corrects many of the shortcomings of active management:

- It can do much of what people do, generally without making "human mistakes."
- It can handle infinitely more data.
- It excludes emotion; it never buys on euphoria or sells in panic.
- It never forgets to rebalance: to sell the things that are expensive and buy the things that are cheap.

Quantitative investing makes good use of the ability of computers to handle vast amounts of data and their freedom from human error. **In short, I think computers can do more than the vast majority of investors, and do it better.**

Now for limitations. I think of quantitative investing as also a free-riding strategy: it profits from disequilibria caused by others. **The supply of "nickels and dimes" is limited to the extent of those disequilibria, and thus only a limited amount of capital can be run this way to great advantage.** There has to be a reason why the best quant firm – Renaissance Technologies – has returned all outside capital from its flagship Medallion Fund; if an investment approach is infinitely scalable, by definition it's never economic to limit the capital under management. (Of course, all "alpha strategies" are based on taking advantage of the errors of others; thus the opportunities are limited to the scale of the errors – see "It's All a Big Mistake" from June 20, 2012.)

And there are bigger-picture questions: **Can quantitative investing make superior qualitative decisions? And can it invest for the long term?**

This brings me back to one of my very favorite quotations. It's from sociologist William Bruce Cameron, although many people attribute it to Albert Einstein (I've done so in the past):

> **. . . not everything that can be counted counts, and not everything that counts can be counted.**

Computers can do an unmatched job dealing with the things that can be counted: things that are quantitative and objective. But many other things – qualitative, subjective things – count for a great deal, and I doubt computers can do what the very best investors do:

- Can they sit down with a CEO and figure out whether he's the next Steve Jobs?
- Can they listen to a bunch of venture capital pitches and know which is the next Amazon?
- Can they look at several new buildings and tell which one will attract the most tenants?
- Can they predict the outcome of a bankruptcy reorganization where the parties may have motivations other than economic maximization?

Further, quantitative investing's emphasis on profiting from short-term dislocations leaves a lot more to be mined. So much of investing these days considers only the short run that I think there's great scope for superior active investors to make value-additive decisions concerning the long run. I have no reason to believe computers can make these in a superior way.

The greatest investors aren't necessarily better than others at arithmetic, accounting or finance; their main advantage is that they see merit in qualitative attributes and/or in the long run that average investors miss. And if computers miss them too, I doubt the best few percent of investors will be retired anytime soon.

Will machine learning enable computers to study the entirety of financial history, figure out what made for the most successful investments, and sense what will work in the future? I have no way of knowing, but even if so, I think that's not enough. **Computers, artificial intelligence and big data will help investors know more and make better quantitative decisions. But until computers have creativity, taste, discernment and judgment, I think there'll be a role for investors with alpha.**

(My confidence that our jobs are safe is not unlimited, however. It's interesting to note that in 2016, a group at Stanford developed a computer program that correctly distinguished between suspenseful and non-suspenseful written passages 81% of the time. The researchers got it to do this by agreeing on what features contribute to suspense and then getting the program to recognize them and learn to identify new ones.)

Importantly, the trends toward both quantitative investing and artificial intelligence presuppose the availability of vast amounts of data regarding fundamentals and prices. A great deal of such data is on hand with regard to public companies and their securities. On the other hand, many of the things Oaktree and other alternative investors are involved in are private, non-traded and relatively undocumented: things like distressed debt, direct lending, private equity, real estate and venture capital. AI/machine learning eventually will make its way into these fields, but a good bit of time is likely to pass before it is sufficiently sophisticated and data is sufficiently available to permit computers to act autonomously.

Finally, I view this situation kind of like index investing: if the day comes when intelligent machines run all the money, won't they all (a) see everything the same, (b) reach the same conclusions, (c) design the same portfolio, and thus (d) perform the same? **What, then, will be the route to superior performance? Humans with superior insight. At least that's my hope.**

June 18, 2018

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Seven Worst Words in the World

I have a new book coming out next week titled *Mastering the Market Cycle: Getting the Odds on Your Side*. It's not a book about financial history or economics, and it isn't highly technical: there are almost no numbers in it. Rather, the goal of the book, as with my memos, is to share how I think, this time on the subject of cycles. As you know, it's my strong view that, while they may not know what lies ahead, investors can enhance their likelihood of success if they base their actions on a sense for where the market stands in its cycle.

The ideas that run through the book are best captured by an observation attributed to Mark Twain: "History doesn't repeat itself, but it does rhyme." While the details of market cycles (such as their timing, amplitude and speed of fluctuations) differ from one to the next, as do their particular causes and effects, there are certain themes that prove relevant in cycle after cycle. The following paragraph from the book serves to illustrate:

> The themes that provide warning signals in every boom/bust are the general ones: that excessive optimism is a dangerous thing; that risk aversion is an essential ingredient for the market to be safe; and that overly generous capital markets ultimately lead to unwise financing, and thus to danger for participants.

An important ingredient in investment success consists of recognizing when the elements mentioned above make for unwise behavior on the part of market participants, elevated asset prices and high risk, and when the opposite is true. We should cut our risk when trends in these things render the market precarious, and we should turn more aggressive when the reverse is true.

One of the memos I'm happiest about having written is *The Race to the Bottom* from February 2007. It started with my view that investment markets are an auction house where the item that's up for sale goes to the person who bids the most (that is, who's willing to accept the least for his or her money). **In investing, the opportunity to buy an asset or make a loan goes to the person who's willing to pay the highest price, and that means accepting the lowest expected return and shouldering the most risk.**

- Like any other auction, when potential buyers are scarce and don't have much money or are reluctant to part with the money they have, the things on sale will go begging and the prices paid will be low.
- But when there are many would-be buyers and they have a lot of money and are eager to put it to work, the bidding will be heated and the prices paid will be high. When that's the case, buyers won't get much for their money: all else being equal, prospective returns will be low and risk will be high.

Thus the idea for this memo came from the seven worst words in the investment world: "too much money chasing too few deals."

In 2005-06, Oaktree adopted a highly defensive posture. We sold lots of assets; liquidated larger distressed debt funds and replaced them with smaller ones; avoided the high yield bonds of the most highly levered LBOs; and generally raised our standards for the investments we would make. Importantly, whereas the size of our distressed debt funds historically had ranged up to $2 billion or so, in early 2007 we announced the formation of a fund to be held in reserve until a special buying opportunity materialized. Its committed capital eventually reached nearly $11 billion.

What caused us to turn so negative on the environment? The economy was doing quite well. Stocks weren't particularly overpriced. And I can assure you we had no idea that sub-prime mortgages and sub-prime mortgage backed securities would go bad in huge numbers, bringing on the Global Financial Crisis. Rather, the reason was simple: with the Fed having cut interest rates in order to prevent problems, investors were too eager to deploy capital in risky but hopefully higher-returning assets. Thus almost every day we saw deals being done that we felt wouldn't be doable in a market marked by appropriate levels of caution, discipline, skepticism and risk aversion. As Warren Buffett says, "the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." **Thus the imprudent deals that were getting done in 2005-06 were reason enough for us to increase our caution.**

<u>The Current Environment</u>

What are the elements that have created the current investment environment? In my view, they're these:

- In order to counter the contractionary effects of the Crisis, the world's central banks flooded their economies with liquidity and made credit available at artificially low interest rates.
- This caused the yields on investments at the safer end of the risk/return continuum to range from historically low in the United States to negative (and near zero) in Europe and elsewhere. At least some of the money that in the past would have gone into low-risk investments, such as money market instruments, Treasurys and high grade bonds, turned elsewhere in search of more suitable returns. (In the U.S. today, most endowments and defined-benefit pension funds require annual returns in the range of 7½-8%. It's interesting to note that the notion of required returns is much less prevalent among investing institutions outside the U.S., and where they do exist, the targets are much lower.)
- Whereas I thought while it was raging that the pain of the Crisis would cause investors to remain highly risk-averse for years – and thus to refuse to provide risk capital – by injecting massive liquidity into the economy and lowering interest rates, the Fed limited the losses and forced the credit window back open, rekindling investors' willingness to bear risk.
- The combination of the need for return and the willingness to bear risk caused large amounts of capital to flow to the smaller niche markets for risk assets offering the possibility of high returns in a low-return world. And what are the effects of such flows? Higher prices, lower prospective returns, weaker security structures and increased risk.

In the current financial environment, the number "ten" has taken on particular significance:

- **This month marks the tenth anniversary of Lehman Brothers' bankruptcy filing on September 15, 2008**, and with it the arrival of the terminal melt-down phase of the Crisis.

- Thanks to the response of the Fed and the Treasury to the Crisis, **the U.S. has seen roughly ten years of artificially low interest rates, quantitative easing and other forms of stimulus.**
- **The resulting economic recovery in the U.S. has entered its tenth year** (and it's worth noting that the longest U.S. recovery on record lasted ten years).
- **The market's upswing from its low during the Crisis is in its tenth year.** Some people define a bull market as a period in which a market rises without experiencing a drop of 20%. On August 22, the S&P 500 passed the point at which it had done so for 3,453 days (113 months), making this the longest bull market in history. (Some quibble, since the market could be said to have risen for 4,494 days in 1987-2000 if you're willing to overlook a decline in 1990 of 19.92% – i.e., not quite 20%. I don't think the precise answer on this subject matters. What we can say for sure is that stocks have risen for a long time.)

What are the implications of these events? I think they're these:

- **Enough time has passed for the trauma of the Crisis to have worn off; memories of those terrible times to have grown dim; and the reasons for stringent credit standards to have receded into the past.** My friend Arthur Segel was head of TA Associates Realty and now teaches real estate at Harvard Business School. Here's how he recently put it: "I tell my students real estate has ten-year cycles, but luckily bankers have five-year memories."
- Investors have had plenty of time to get used to monetary stimulus and reliance on the Fed to inject liquidity to support economic activity.
- While there certainly is no hard-and-fast rule that limits economic recoveries to ten years, it seems reasonable to assume based on history that the odds are against a ten-year-old recovery continuing much longer. (On the other hand, since the current recovery has been the slowest since World War II, it's reasonable to believe there haven't been the usual excesses that require correcting, bringing the recovery to an end. And some observers feel that in the period ahead, a proactive or politicized Fed might well return to cutting interest rates – or at least stop raising them – if weakness materializes in the economy or the stock market.)
- **Finally, it's worth noting that nobody who entered the market in nearly ten years has experienced a bear market or even a really bad year, or seen dips that didn't correct quickly. Thus newly minted investment managers haven't had a chance to learn firsthand about the importance of risk aversion, and they haven't been tested in times of economic slowness, prolonged market declines, rising defaults or scarce capital.**

For the reasons described above, I feel the requirements have been fulfilled for a frothy market as set forth in the citation from my new book on this memo's first page.

- Investors may not feel optimistic, but because the returns available on low-risk investments are so low, they've been forced to undertake optimistic-type actions.
- Likewise, in order to achieve acceptable results in the low-return world described above, many investors have had to abandon their usual risk aversion and move out the risk curve.
- As a result of the above two factors, capital markets have become very accommodating.

Do you disagree with these conclusions? If so, you might not care to read further. But these are my conclusions, and they're the reason for this memo at this time.

*   *   *

In memos and presentations over the last 14 months, I've made reference to some specific aspects of the investment environment. These have included:

- the FAANG companies (Facebook, Amazon, Apple, Netflix and Google/Alphabet), whose stock prices incorporated lofty expectations for future growth;
- corporate credit, where the amounts outstanding were increasing, debt ratios were rising, covenants were disappearing, and yield spreads were shrinking;
- emerging market debt, where yields were below those on U.S. high yield bonds for only the third time in history;
- SoftBank, which was organizing a $100 billion fund for technology investment;
- private equity, which was able to raise more capital than at any other time in history; and
- cryptocurrencies led by Bitcoin, which appreciated by 1,400% in 2017.

I didn't cite these things to criticize them or to blow the whistle on something amiss. Rather I did so because phenomena like these tell me the market is being driven by:

- optimism,
- trust in the future,
- faith in investments and investment managers,
- a low level of skepticism, and
- risk tolerance, not risk aversion.

In short, attributes like these don't make for a positive climate for returns and safety. Assuming you have the requisite capital and nerve, the big and relatively easy money in investing is made when prices are low, pessimism is widespread and investors are fleeing from risk. The above factors tell me this is not such a time.

A Case In Point: Direct Lending

In the years immediately following the Crisis, the banks – which remained traumatized and in many cases were marked by low capital ratios – were reluctant to do much lending. Thus a few bright credit investors began to organize funds to engage in "direct lending" or "private lending." With the banks hamstrung by regulations and limited capital, non-bank entities could be selective in choosing their borrowers and could insist on high interest rates, low leverage ratios and strong asset protection.

Not all investors participated in the early days of 2010-11. But many more got with the program in later years, after private lending had caught on and more managers had organized direct-lending funds to accommodate them. As the *Wall Street Journal* wrote on August 13:

> The influx of money has led to intense competition for borrowers. On bigger loans, that has driven rates closer to banks' and led to a loosening of credit terms. For smaller loans, "I don't think it could become any more borrower friendly than it is today," said Kent Brown, who advises mid-sized companies on debt at investment bank Capstone Headwaters.

> The market is poised to grow as behemoths and smaller outfits angle for more action. . . . Overall, firms completed fundraising on 322 funds dedicated to this type of lending between 2013 and 2017, **with 71 from firms that had never raised one before**, according to data-provider Preqin. That compares with 85 funds, including 19 first-timers, in the previous five years. (Emphasis added)

And what about the quality of the loans being made? The *Journal* goes on:

> Companies often turn to direct lenders because they don't meet banks' criteria. A borrower may have a one-time blip in its cash flows, have a lot of debt or operate in an out-of-favor sector. . . .
>
> Direct loans are typically floating-rate, meaning they earn more in a rising-rate environment. But borrowers accustomed to low rates may be unprepared for a jump in interest costs on what is often a big pile of debt. That risk, combined with the increasingly lenient terms and the relative inexperience of some direct lenders, could become a bigger issue in a downturn.

Observations like these tempt me to apply what I consider the #1 investment adage: "What the wise man does in the beginning, the fool does in the end." It seems obvious that direct lending is taking place today in a more competitive environment. More people are lending more money today, and they're likely to compete for opportunities to lend by lowering their standards and easing their terms. That makes this form of lending less attractive than it used to be, all else being equal.

Has direct lending reached the point at which it's wrong to do? Nothing in the investment world is a good idea or a bad idea *per se*. **It all depends on when it's being done, and at what price and terms, and whether the person doing it has enough skill to take advantage of the mistakes of others, or so little skill that he or she is the one committing the mistakes.**

At the present time, the managers raising and investing large funds are showing the most growth. But in the eventual economic correction, they may be shown to have pursued asset growth and management fees over the ability to be selective regarding the credits they backed.

Lending standards and credit skills are seldom tested in positive times like we've been enjoying. That's what Warren Buffett had in mind when he said, "It's only when the tide goes out that you learn who has been swimming naked." **Skillful, disciplined, careful lenders are likely to get through the next recession and credit crunch. Less-skilled managers may not.**

<u>Signs of the Times</u>

Unfortunately, there is no single reliable gauge that one can look to for an indication of whether market participants' behavior at a point in time is prudent or imprudent. All we can do is assemble anecdotal evidence and try to draw the correct inferences from it. Here are a few observations regarding the current environment (all relating to the U.S. unless stated otherwise):

Debt levels:

- "One remarkable feature of the past decade is that between 2007 and 2017, the ratio of global debt to GDP jumped from 179 per cent to 217 per cent, according to the Bank for International Settlements." (*Financial Times*)
- "In the last year Congress has passed a gargantuan tax cut and spending increase that, according to Deutsche Bank, represents the largest stimulus to the economy outside of a recession since the 1960s. It sets the federal debt, already the highest relative to GDP since the 1940s, on an even steeper trajectory [and] stimulates an economy already at or above full employment which could fuel inflation . . ." (*Wall Street Journal*)
- "Debt levels crept up as central banks suppressed [interest rates], with the proportion of global highly-leveraged companies – those with a debt-to-earnings ratio of five times or greater – hitting 37 percent in 2017 compared with 32 percent in 2007, according to S&P Global Ratings." (*Bloomberg*)
- The debt of U.S. non-financial corporations as a percent of GDP has returned to its Crisis level and is near a post-World War II high. (*New York Times*)
- Total leveraged debt outstanding (high yield bonds and leveraged loans) is now $2.5 trillion, exactly double the amount in 2007. Leveraged loans have risen from $500 billion in 2008 to almost $1.1 trillion today. (*S&P Global Market Intelligence*)
- Most of this growth has been in levered loans, not high yield bonds. Whereas the amount of high yield bonds outstanding is roughly unchanged from the end of 2013, leveraged loans are up $400 billion. In the process, we think the risk level has risen in loans while remaining stable in high yield bonds. These trends in loans are due in large part to strong demand from new Collateralized Loan Obligations and other investors seeking floating-rate returns.
- "Some $104.6 billion of new [leveraged] loans were made in May, according to Moody's Investors Service, topping a previous record of $91.4 billion set in January 2017, and the pre-crisis high of $81.8 billion in November 2007." (*Barron's*)
- BBB-rated bonds – the lowest investment grade category – now stand at $1.4 trillion in the U.S. and constitute the largest component of the investment grade universe (roughly 47% in both the U.S. and Europe, up from 35% and 19%, respectively, ten years ago). (*IMF, NYT*)
- The amount of CCC-rated debt outstanding currently stands 65% above the record set in the last cycle. (It is, however, down 10% from the peak in 2015, thanks primarily to reduced issuance of CCCs; numerous defaults of energy-related CCCs; and strong demand – largely from CLOs – for first lien loans rated B-, which otherwise might have been unsecured CCC bonds.) (*Credit Suisse*)

Quality of debt:

- The average debt multiple of EBITDA on large corporate loans is just above the previous high set in 2007; the average multiple on large LBO loans is just below the 2007 high; and the average multiple on middle market loans is at a clear all-time high. (*S&P GMI*)
- $375 billion of covenant-lite loans were issued in 2017 (75% of total leveraged loan issuance), up from $97 billion (and 29% of total issuance) in 2007. (*S&P GMI*)
- BB-rated high yield bonds are now coming to market with the looser covenants common in investment grade bonds.
- More than 30% of LBO loans (and more than 50% of M&A loans) incorporate "EBITDA adjustments" these days, versus roughly 7% and 25%, respectively, ten years ago. A mid-

teens percentage of LBO loans include adjustments of more than 0.5x EBITDA, as opposed to a few percent ten years ago. (*S&P GMI*)

- Loans to raise money for stock buybacks or dividends to equity owners are back to pre-Crisis levels. (*S&P GMI*)
- The all-in yield spread on BB/BB- institutional loans is down to 200-250 basis points, as opposed to roughly 300-400 bps in late 2007/early 2008. Spreads on B+/B loans also have narrowed by 100-150 bps. (*S&P GMI*)

Other observations:

- At the beginning of 2018, 2,296 private equity funds were in fund-raising mode, seeking $744 billion of equity capital. (*FT*) These are all-time highs.
- As of June, SoftBank had been able to raise $93 billion of the $100 billion it sought for its Vision Fund for technology investments, and it was trying to raise $5 billion of the remainder from an incentive scheme for its employees. Lacking capital, the employee pool would borrow it from SoftBank, which in turn hoped to borrow it from Japanese banks. (*FT*)
- Challenged to bid for deals against SoftBank's huge firepower, other venture capital funds are expanding in response. They're seeking capital in much greater amounts than they invested in the past, and investors – attracted by the returns being reported by the best funds – are eager to supply it. Of course this onslaught of money is bound to have a deleterious impact on future returns.
- "According to Crunchbase, there have been 268 [venture capital] mega-rounds ($100 million rounds), invested during the first seven months of this year, almost equal to a record of 273 mega-rounds for the entire year of 2017. And during the month of July alone, there were 50 financing deals totaling $15 billion, which is a new monthly high." (*The Robin Report*)
- From 2005 to 2015, the oil fracking industry increased its net debt by 300 percent, even though, according to Jim Chanos, from mid-2012 to mid-2017 the 60 biggest fracking firms had negative cash flow of $9 billion per quarter. "Interest expenses increased at half the rate debt did because interest rates kept falling," said a Columbia University fellow. (*NYT*)
- Student debt has more than doubled since the Crisis, to $1.5 trillion, and the delinquency rate has risen from 7½% to 11%. (*NYT*)
- Personal loans are surging, too. The amount outstanding reached $180 billion in the first quarter, up 18%. "Fintech companies originated 36% of total personal loans in 2017 compared with less than 1% in 2010, Chicago-based TransUnion said." (*Bloomberg*)
- Emerging market countries have been able to issue vast amounts of debt, much of it repayable in dollars and euros to which they have only limited access. "According to the Bank for International Settlements, . . . the total amount of dollar-based loans [worldwide] has jumped from $5.8 trillion in the first quarter of 2009 to $11.4 trillion today. Of that, $3.7 trillion has gone to emerging markets, more than doubling in that period." (*NYT*)
- In a relatively minor but extreme example, yield-hungry Japanese investors poured several billion dollars into so-called "double-decker" funds that invested in Turkish assets and/or swapped into wrappers denominated in high-yielding (but depreciating) Turkish lira. (*FT*)

Moving on from the general to the specific, I've asked Oaktree's investment professionals, as I did at the time of *The Race to the Bottom*, for their nominees for imprudent deals they've seen. Here's the evidence they provided of a heated capital market and a strong appetite for risk, with their commentary in quotes in a few cases. (Since my son Andrew often reminds me of Warren Buffett's admonition, "praise by name, criticize by category," I won't identify the companies involved.)

- Capital equipment company A issued debt to finance its acquisition by a private equity fund. "While we thought the initial price talk was far too tight, the deal was oversubscribed and upsized, and the pricing was tightened by 25 bps. Final terms were highly aggressive with covenant-lite structure, uncapped adjustments to EBITDA, and a large debt incurrence capacity." The company missed expectations in the first two quarters after issuance, in reaction to which the first lien loan traded down by as much as five points and the high yield bonds traded down by as much as 15.
- The European market isn't insulated from the trend toward generosity. Company B is a good services company, albeit with exposure to cyclical end-markets; is smaller than its peers; has lower margins, higher leverage and limited cash-generation ability; and went through a restructuring a few years ago. Nevertheless, on the back of adjusted EBITDA equal to 150% of its reported figure, the company was able to issue seven-year bonds paying just over 5%.
- Energy product company C recently went public. Despite a retained deficit of $2.4 billion and an S-1 stating "we have incurred significant losses in the past and do not expect to be profitable for the foreseeable future," its shares were oversubscribed at the IPO price and are now selling 67% higher. One equity analyst says that's a reasonable valuation, since it's 5x estimated 2020 <u>revenues</u>. Another has a target price 25% <u>below</u> the current price, although to get to that valuation the analyst assumes the company will be able to expand its gross margin by 30% a year for the next 12 years and be valued at 6x EBITDA in 2030.
- Over the last two years, company D has spent an amount on buybacks equal to 85% of a year's EBITDA. In part because of the buybacks, the company now has much more debt than it did two years ago. In contrast to the last two years, we estimate that in the seven preceding years, it spent only one-tenth as much on buybacks as in the last two years, at an average purchase price 85% below the more recent average.
- A buyout fund just bought company E, a terrific company, for 15x EBITDA, a very high "headline figure." The price is based on adjusted EBITDA which is 125% of reported EBITDA; thus the transaction price equates to 19x reported EBITDA. Stated leverage is 7x adjusted EBITDA, meaning 9x reported EBITDA. "We aren't saying this will wind up being a bad deal. Just saying that IF this ends up being a bad deal, no one will be surprised. Everyone will say, with the benefit of hindsight, 'they paid way too much and put way too much debt on the balance sheet, and it was doomed out of the gate.' "
- Company F earns substantial EBITDA, but 60% comes from a single unreliable customer, and its growth is constrained by geography. We arrived at a price where we thought it would constitute a good investment for us. But the owners wanted twice as much . . . and they got it from a buyout fund. "We are generally seeing financial sponsors being very aggressive, pricing to perfection with very little room for error, on the back of very liberal lending practices by banks and non-traditional lenders. We all know how this will end."
- A year ago, a buyout fund financed the acquisition of company G by one of its portfolio companies with 100% debt <u>and</u> took out a dividend for itself. The deal was marketed with an adjusted EBITDA figure that was 190% of the company's reported EBITDA. Based on the adjusted figure, total leverage was more than 7x, and based on the reported figure it was 13.5x. The bonds are now trading above par, and the yield spread to worst on the first lien notes is below 250 bps.
- Company H is a good, growing company that we were ready to exit, and our bankers sent out 100 "teasers." We received 35 indications of interest: three from strategic buyers and 32 from financial sponsors. "The strategic buyers offered the lowest valuations; it's always a big warning sign when financial sponsors with no hope of synergies are offering prices much

higher than strategics." We received four purchase offers from buyout funds, one with the price left blank. We ended up selling at 14x EBITDA, with total leverage of more than 7x.

- In 2017, investors bought over $10 billion of debt from Argentine and Turkish local-currency-earning corporates that now trades, on average, 500 bps wider than at issuance (e.g., at an 11% yield today versus 6% at issue).
- The high point in emerging market debt (or was it the low point?) was Argentina's ability in June 2017 to issue $2.75 billion of oversubscribed 100-year bonds despite a financial history marked by crises in 1980, 1982, 1984, 1987, 1989 and 2001. The bond was priced at 90 for a yield of 7.92%. Now it's trading at 75, implying a mark-down of 17% in 16 months.

Of particular note, David Rosenberg, Oaktree's co-portfolio manager for U.S. high yield bonds, provides an example of post-Crisis restraints being loosened. The government's Leverage Lending Guidelines, "introduced in 2013 to curb excessive risk-taking, capped leverage at 6x – subject to certain conditions – and contributed to less aggressive dealmaking [*sic*] among regulated banks. . . ." Now the head of the Office of the Comptroller of the Currency has indicated, "it's up to the banks to decide what level of risk they are comfortable with in leveraged lending. . . ." Here's what the OCC head said on the subject: "What we are telling banks is you have capital and expected loss models and so if you are reserving sufficient capital against expected losses, then you should be able to make that decision." (The quotes above are from *Debtwire.*) And here's my response: how did that work out last time?

David goes on: "Not surprisingly, bankers have told me they are now testing the waters with 7.5x levered LBOs. **A banker recently told me that for the first time since 2007, he has been in a credit review and heard the credit deputy rationalize approving a risky deal because it is a small part of a larger portfolio so they can afford for it to go wrong, and if they pass on the deal they will lose market share to their competitors**." That sounds an awful lot like "if the music's playing, you've gotta dance." I repeat: how'd that work out last time?

The bottom-line question is simple: does the sum of the above evidence suggest today's market participants are guarded or optimistic? Skeptical or accepting of easy solutions? Insisting on safety or afraid of missing out? Prudent or imprudent? Risk-averse or risk-tolerant? To me, the answer in each case favors the latter, meaning the implications are clear.

* * *

Before closing, I want to share my view that equities are priced high but (other than a few specific groups, such as technology and social media) not extremely high – especially relative to other asset classes – and are unlikely to be the principal source of trouble for the financial markets. I find the position of equities today similar to that in 2005-06, from which they played little or no role in precipitating the Crisis. (Of course, that didn't exempt equity investors from pain; they were hit nevertheless with declines of more than 50%.)

Instead of equities, the main building blocks for the Crisis of 2007-08 were sub-prime mortgage backed securities, other structured and levered investment products fashioned from debt, and derivatives, all examples of financial engineering. In other words, not securities and debt instruments themselves, but the uses to which they were put.

This time around, it's mainly public and private debt that's the subject of highly increased popularity, the hunt by investors for return without commensurate risk, and the aggressive behavior described above. Thus it appears to be debt instruments that will be found at ground zero when things next go wrong. As often, *Grant's Interest Rate Observer* puts it well:

> Naturally, the lowest interest rates in 3,000 years have made their mark on the way people lend and borrow. Corporate credit, as [Wells Fargo Securities analyst David] Preston observes, is "lower-rated and higher-levered. This is true of investment-grade corporate debt. This is true in the loan market. This is true in private credit."
>
> So corporate debt is a soft spot, perhaps *the* soft spot of the cycle. It is vulnerable not in spite of, but because of, resurgent prosperity. The greater the prosperity (and the lower the interest rates), the weaker the vigilance. It's the vigilance deficit that crystalizes the errors that lead to a crisis of confidence.

Conditions overall aren't nearly as bad as they were in 2007, when banks were levered 32-to-1; highly levered investment products were being invented (and swallowed) daily; and financial institutions were investing heavily in investment vehicles built out of sub-prime mortgages totally lacking in substance. **Thus I'm not describing a credit bubble or predicting a resulting crash.** But I do think this is the kind of environment – marked by too much money chasing too few deals – in which investors should emphasize caution over aggressiveness.

On the other hand – and in investing there's always another hand – there is little reason to think today's risky behavior will result in defaults and losses until we see serious economic weakness. And there's certainly no reason to think weakness will arrive anytime soon. The economy, growing but relatively free of excesses, feels right now like it could go on a good bit longer.

But on the third hand, the possible effects of economic overstimulation, increasing inflation, contractionary monetary policy, rising interest rates, rising corporate debt service burdens, soaring government deficits and escalating trade disputes do create uncertainty. And so it goes.

*   *   *

Being alert for the ability of others to issue flimsy securities and execute fly-by-night schemes is a big part of what I call "taking the temperature of the market." By also incorporating awareness of historically high valuations and euphoric investor attitudes, taking the temperature can give us a sense for whether a market is elevated in its cycle and it's time for increased defensiveness.

This process can give you a sense that the stage is being set for losses, although certainly not when or to what extent a downturn will occur. Remember that *The Race to the Bottom*, which in retrospect seems to have been correct and timely, was written in February 2007, whereas the real pain of the Global Financial Crisis didn't set in until September 2008. Thus there were 19 months when, according to the old saying, "being too far ahead of one's time was indistinguishable from being wrong." In investing we may have a sense for what's going to happen, but we never know when.

Thus the best we can do is turn cautious when the situation becomes precarious. We never know for sure when – or even whether – "precarious" is going to turn into "collapse."

To close, I'm going to recycle two of the final paragraphs of *The Race to the Bottom*. Doing so permits me to provide an excellent example of history's tendency to rhyme:

> Today's financial market conditions are easily summed up: There's a global glut of liquidity, minimal interest in traditional investments, little apparent concern about risk, and skimpy prospective returns everywhere. Thus, as the price for accessing returns that are potentially adequate (but lower than those promised in the past), investors are readily accepting significant risk in the form of heightened leverage, untested derivatives and weak deal structures. . . .
>
> This memo can be recapped simply: there's a race to the bottom going on, reflecting a widespread reduction in the level of prudence on the part of investors and capital providers. No one can prove at this point that those who participate will be punished, or that their long-run performance won't exceed that of the naysayers. But that is the usual pattern.

It's now eleven years later, but I can't improve on that.

I'm absolutely not saying people shouldn't invest today, or shouldn't invest in debt. Oaktree's mantra recently has been, and continues to be, "move forward, but with caution." The outlook is not so bad, and asset prices are not so high, that one should be in cash or near-cash. The penalty in terms of likely opportunity cost is just too great to justify being out of the markets.

But for me, the import of all the above is that investors should favor strategies, managers and approaches that emphasize limiting losses in declines above ensuring full participation in gains. You simply can't have it both ways.

Just about everything in the investment world can be done either aggressively or defensively. In my view, market conditions make this a time for caution.

September 26, 2018

Memo to: Oaktree Clients

From: Howard Marks

Re: Political Reality Meets Economic Reality

In 2016 I wrote *Economic Reality* (in May) and *Political Reality* (in August), two memos covering subjects I thought were important and timely. In the latter, I summed up *Economic Reality* as follows:

> [It] describes the ways in which economics defines and constrains reality in business, investing and everyday life. Economics establishes the rules of the game and the boundaries of the playing field, and these things can't be ignored. They can be altered, but not without consequences.
>
> The realities of economics are stark and consistent, but also logical. They aren't absolute, like the laws of physics (e.g., gravity), but they reliably establish tendencies and limits.

The point is that the field of economics covers the choices people and organizations face; the costs, possible rewards and potential consequences; and how decisions regarding those choices are made. These are the bases on which people enter into economic transactions. More than anything else, perhaps, economics is the study of choice.

Three months later, in *Political Reality*, I said:

> I've always gotten a kick out of oxymorons – phrases that are internally contradictory – such as "jumbo shrimp" and "common sense." I'll add "political reality" to the list. The world of politics has its own, altered reality, in which economic reality often seems not to impinge. No choices need be made: candidates can promise it all. And there are no consequences. If something might have negative consequences in the real world, politicians seem to feel free to ignore them. . . .

The purpose of this memo is to describe what happens when political behavior collides with economic reality, as illustrated in one area where the government is taking steps – tariffs – and another in which debate among politicians is heating up – restrictions on the capitalist system.

Before I move forward, I'd like to state up front, as I did in *Economic Reality* in 2016, that I'm not writing to make political judgments or to make any politician or party look bad. But economic pronouncements can't be separated from the people who make them. If you read through to the end, you'll see I find something to complain about in the approach of members of both parties.

Tariffs

Tariffs are very much in the news these days, and their complexity renders them ripe for error and thus appropriate for discussion here.

Many people – albeit President Trump's supporters more often than economists in general – applaud his decision to impose tariffs against China. Whereas the simple story was that he was doing so to (a) reduce our trade deficit with China, (b) support U.S. manufacturers and (c) protect U.S. jobs, there's more in play. In *The Wall Street Journal* of October 20, Richard Haass, president of the Council on Foreign Relations, an independent, nonpartisan organization, enumerated complaints that have been lodged against China in the area of trade:

> . . . higher-than-warranted tariff and non-tariff barriers, forced transfers of technology, theft of intellectual property, government subsidies and currency manipulation designed to make exports cheaper and to reduce the demand for imports.

Everyone knowledgeable tells me these complaints are warranted. While they're not new, past presidents don't seem to have done much about them, or at any rate didn't produce any results. Clearly Trump likes to take action and doesn't shy away from confrontation. Given that China's economy is much more reliant on exports to the U.S. than ours is on exports to China – and given China's need for rapid economic growth in order to reach its goals – imposing tariffs represents a possible way for Trump to get China to alter its behavior.

Thus rather than criticize Trump's tariffs, I'm going to use them as an example to illustrate the central messages of this memo: (a) economic actions have costs and consequences, (b) for that reason, it's generally safe to say there are no simple solutions to complex problems, (c) given the complexities, few people thoroughly understand economics, and (d) because of that understanding deficit, politicians' proposed solutions often fail to receive the scrutiny they should.

First, there's misunderstanding. The U.S. runs chronic trade deficits with most of its trading partners, and with China it amounted to $335 billion in 2017. Trump takes these deficits to mean our trading partners are winning and we're losing. "We have countries ripping us off for years. . . . We have trade deficits; they have surpluses." In particular, he says "China's been killing us," suggesting there's something nefarious about trade deficits. But is that the correct inference? The other day I went to the barber for a haircut, and when I paid him, I ran a trade deficit. He got my money, and I got a haircut. I didn't feel like I had lost. Likewise, Chinese businesses make money from the U.S., and U.S. consumers get the low-priced goods they want. **Both sound like winners to me.**

Trump has said, "If we didn't trade, we'd save a hell of a lot of money." Would we? That would be true only if we didn't otherwise buy the things we've been importing, or if we were able to buy them cheaper domestically. Would it really save us money to not trade with China?

After all, who pays tariffs? They're a tax paid by exporters and presumably passed on to consumers in the countries into which goods are imported. So it's not enough to say "exporters are paying increased tariffs." It's also likely that U.S. consumers are paying increased prices for the goods they consume.

If tariffs are paid by consumers in the importing nations, what's to be accomplished by imposing them? **In short, it's done to raise the cost of foreign goods and thus discourage their consumption. But that leads us to the knock-on effects: what else happens?**

Let's take the first shot fired in last year's escalation on trade: the imposition of tariffs of 25% on imported steel and 10% on imported aluminum. Here are some of the many possible complications, ramifications and second-order consequences:

- Tariffs on imported intermediate goods such as steel and aluminum might increase the cost of finished goods manufactured in the U.S., rendering them less competitive if their prices are raised (or less profitable if they're not). According to *The New York Times* of July 4, 2018:

  > The Aluminum Association, which represents the bulk of the American industry, says that 97 percent of American jobs in aluminum are at what are called "downstream" businesses that shape the metal into things like auto parts and other goods. Those companies are hurt by Mr. Trump's tariffs, because they now must pay higher prices for their raw materials.

- To avoid paying tariffs, American manufacturers could reduce their imports of foreign steel and aluminum for use in the finished goods they make, and instead increase their imports of finished goods – which are not subject to the tariffs – made abroad with foreign steel and aluminum.

- Going beyond importing finished goods, American companies could move their manufacturing overseas, cutting domestic jobs. The overseas use of untaxed, low-cost metals could provide a competitive edge when those finished goods are imported into the U.S.

- Non-U.S. companies likewise could gain an advantage over their American competitors. Their use of untaxed, low-cost materials could give them lower selling prices or higher profit margins when exporting finished goods to the U.S.

- Despite the cost increases caused by tariffs, imports might not actually be discouraged and U.S. production encouraged, simply because U.S. capacity doesn't exist:

  > "The reality is there's not enough aluminum made here," said Eric Krepps, who runs the North American automotive business at Constellium NV, a Dutch aluminum company. "We could not source everything out of the U.S. even if we wanted to," . . . since the U.S. produces just 13% of the 5.6 million metric tons of raw aluminum it uses each year. (*The Wall Street Journal*, July 18, 2018)

- Since tariffs might raise selling prices on imported goods (or goods incorporating imported materials and components), the reduced competitiveness of those imports could enable domestic producers to raise their prices. The result would be higher consumer prices on all brands.

- Countries whose goods are subjected to tariff increases are unlikely to just sit there and take it. Retaliation is always a reasonable expectation. "While tariffs help some companies, they have the potential to hurt thousands of others. Businesses that depend on access to overseas markets are being hit with retaliatory tariffs . . . ." (*The New York Times*, August 7, 2018)

- Finally, a trade war centered on escalating tariffs makes the global environment less stable, reducing predictability and increasing uncertainty. This isn't good for any economy.

Going beyond steel and aluminum, increased tariffs on imported automobiles and auto components have been under discussion for much of the past year. Some of the considerations described above regarding steel and aluminum don't apply to cars, since they're finished goods, not intermediate goods. But a number of additional elements create exceptional complexity:

- U.S. companies manufacture cars in the U.S. for sale abroad.
- U.S. companies manufacture cars abroad for import to the U.S.
- Some of the biggest manufacturers of cars in the U.S. are non-U.S. companies.
- Many of the cars produced in the U.S. by non-U.S. companies are destined for export.
- Cars made in the U.S. incorporate a lot of components made elsewhere.
- Of the cars sold in the U.S. last year, 44% were imported.

On July 20, *The New York Times* discussed the possibility of increased tariffs on autos as follows:

> If imposed, the tariffs would most likely have deeper and wider-reaching repercussions for the economies than levies on fish or steel. Cars don't come together in one plant, with one work force – they're the final result of hundreds of companies working together in a supply chain that can snake through small American towns and cross oceans.

Thus increased tariffs on automotive imports could bring about:

- an increase in the price of all cars bought by Americans,
- a resultant decline in the number of cars sold,
- tougher times for manufacturers, dealers, support businesses and their employees, and
- thus a general contraction of the economy. (In July the IMF projected that "currently announced tariffs would reduce global economic output by $430 billion, or half a percent, in 2020, if they remained in place and shook consumer confidence." (*The New York Times*, July 23, 2018))

The bottom line is that tariffs aren't a simple solution or a sure thing. They're a tool or tactic with potential benefits, but also costs and risks. They can help some parts of the economy and simultaneously harm others. In other words, they're a tradeoff. That's the key word in economics. The question is whether they're worth it. In good part, it depends on whom you ask.

> One study of the Obama tire tariffs found in a single year, 2011, Americans spent an extra $1.1 billion on tires as a result of a tariff that preserved, at most, 1,200 jobs. That is almost $1 million per job, for jobs paying an average of about $40,000.
>
> Steel tariffs imposed in 2002 by President George W. Bush yielded similar results, penalizing not just consumers but companies that use steel to make other products, like construction companies and carmakers. The Dartmouth economist Douglas Irwin estimated 140,000 American workers make steel, while 6.5 million workers make products that include steel.
>
> "If for some reason you said, 'We just want to help steel producers, shareholders, possibly steel workers,' it makes sense," Mr. Irwin said. "If you care about manufacturing employment or the manufacturing sector, it doesn't make sense." (*The New York Times*, September 17, 2018)

I'll move to wrap up on the subject of tariffs with a few paragraphs from *Economic Reality*:

> Have the voters who think it's a great idea to "bring back the jobs" thought about what goods manufactured at U.S. wages – or tariffs designed to bring the cost of Chinese goods up to those levels – would do to their cost of living? I'd guess not. **How will the interests of the 3.2 million Americans estimated to have lost their manufacturing jobs to China be balanced against the hundreds of millions who would have to pay considerably more for imported goods? Not an easy question.**
>
> Quotas, tariffs and subsidies are all ways for countries to protect industries that can't hold their own against international competitors without these things. Thus they're a good example of ways in which policy decisions can lead to distortions. **Since the industries for which tariffs and subsidies are established are, by definition, industries that can't compete without them, for these things to be enacted, someone has to make a decision that (a) these industries should be kept afloat and (b) consumers of these industries' goods should be prevented from paying the lower prices that would prevail if consumers had easy access to goods from abroad, free of tariffs. . . .**
>
> The bottom line, as with so many of the things I'm discussing here, is that economic laws cannot be ignored or magical solutions willed to appear. While it's far from the entire explanation, the main reason the U.S. has lost manufacturing jobs to foreign countries is that people there are willing to work for much less. **In this globalized world, that means Americans can't enjoy both the high-paying manufacturing jobs they used to have <u>and</u> the low-cost goods they've been buying of late. The imposition of tariffs can't solve that conundrum.**

On two occasions last summer, while discussing the steel and aluminum tariffs, *The Wall Street Journal* did a good job of summing up the key considerations:

> The fallout, while so far limited, illustrates how efforts to protect some companies can cause unintended pain for others. (June 4, 2018)
>
> Put into practice, tariffs are a complex economic weapon that can ricochet through an economy in ways even proponents don't expect. (July 17, 2018)

As mentioned earlier, I'm not writing here to criticize tariffs (or administrations that impose them), but rather to show (a) it's not easy for government actions to improve the functioning of economies and (b) there are ramifications to be considered. Tariffs are typical of economic reality, and economic reality is complex, in large part because it consists mainly of dividing resources among participants, not of creating more for everyone. As economists like to say, "There's no such thing as a free lunch."

<u>Anti-Capitalism</u>

Something else is going on that I worry about far more than the imposition of tariffs: increasing anti-capitalist sentiment.

One of the big trends in politics in recent years has been the rise of populism. While populism is somewhat amorphous, here's a definition for the purposes of this memo:

> A political philosophy supporting the rights and power of the people in their struggle against the privileged elite. (*The Free Dictionary*)

I think it's important to add another word with regard to the adoption of populism as a political strategy: it plays on **resentment** on the part of "the people" toward "the elite."

Populism has been on the rise in Europe for a number of years, generally associated with the political right and characterized by resentment toward economic, liberal and urban elites. It has often been accompanied by authoritarianism, allowing charismatic strongmen to present themselves as protecting "the people" from looming threats like immigration.

A good part of the credit for Donald Trump's election in 2016 has likewise been attributed to populism. This instance, also coming from the right, was largely built on resentment from rural, white, older and less-educated voters directed at urban, establishment, educated and cultural elites, as well as unhappiness with social and demographic trends that are disrupting the status quo.

But as shown in the 2016 presidential Democratic primary contests and since, another wave of populism has arisen from the left. **I'm most concerned that in this case, the principal targets of popular resentment are capitalism and capitalists.**

One of the big stories of the 2016 primary season was the success of avowed Democratic Socialist Senator Bernie Sanders. Sanders launched a challenge to Hillary Clinton, the heir-apparent to the leadership of the Democratic Party and eventually the chosen nominee. He gained a lot of followers and gave Clinton a run for her money, in particular by emphasizing economic justice, the corrosive effect of money (and especially corporate money) in politics, and the promise of healthcare and education for all.

Following on Sanders's performance, the so-called "progressive" or left wing of the Democratic Party is becoming a formidable bloc. **I expect progressives to be a force to be reckoned with in the coming years. They will show up strongly in the 2020 primaries and influence the debate. In fact, their influence is already being seen. And thus this section of my memo.**

In a possibly isolated but telling incident, in a Democratic congressional primary last year in Queens, New York, Alexandria Ocasio-Cortez came from the far left to beat Joe Crowley, a ten-term, center/left congressman. Crowley was #4 in the Democratic leadership in the House of Representatives and considered a likely eventual successor to Nancy Pelosi as House Speaker. Instead he was ousted by Ocasio-Cortez: 28 years old at the time and sporting a storybook bio featuring a working-class upbringing, academic distinction and stints as a bartender and waitress. She had been politically oriented but had never held elected office. And yet she became the youngest woman ever elected to Congress. She's been very outspoken since and has attracted disproportionate attention for a freshman legislator.

Ocasio-Cortez, like Sanders, is a member of the Democratic Socialists of America, and she willingly accepts the label "radical." A *New Yorker* article titled "Left Wing of the Possible" quotes her as follows:

> I do think we are in a crisis of late-stage capitalism, where people are working sixty, eighty hours a week and they can't feed their families. There is a lot that is economically dystopic in this country. So that's why people are open to change. (July 23, 2018)

Julia Salazar, another member of the D.S.A., also ousted a Democratic incumbent last year and won election to the New York State Senate with the "ardent support of Ocasio-Cortez." The same article included a statement from her that I found chilling:

> . . . a democratic socialist "recognizes the capitalist system as being inherently oppressive, and is actively working to dismantle it and to empower the working class and the marginalized in our society."

Does this group genuinely want to abolish capitalism? Thankfully, the same article went on to reflect some moderate sentiment:

> Michael Kazin, a co-editor of *Dissent* and a D.S.A. member, [said]: "The radical left's major influence in American history is to push liberals, progressives, to the left. And that is going to be the impact. I don't believe we are going to have a socialist transformation of America in my lifetime."

In July, *The New York Times* explored the Democratic Socialists' agenda as follows:

> "So what are we talking about here?" the host Stephanie Ruhle asked in an MSNBC segment, with background graphics highlighting that democratic socialism is "NOT Socialism" and "NOT Communism" but something more like a fondness for Social Security and Amtrak. The D.S.A. itself both embraces and rejects such friendly definitions, explaining that it "fights for reforms today" but still seeks to overturn "an international economic order sustained by private profit, alienated labor" and other forms of exploitation. . . .
>
> When today's leftists talk about socialism, they point to places like Sweden and France (home to robust maternity leave and universal health care) or even to lost relics of America's recent past (stable jobs, union power, a collective investment in human welfare). (July 22, 2018)

Ocasio-Cortez and Salazar may not be indicative of a broad movement, as they hail from New York City, where a Democratic candidate is a sure thing in a general election and extremism is unlikely to be an impediment. But some trends among our citizens are very much worth noting. According to the *New Yorker* article cited above:

> In 2016, the Institute of Politics, at Harvard's Kennedy School, polled people between the ages of eighteen and twenty-nine, and discovered that support for capitalism was surprisingly low. Fifty-one percent of the cohort rejected capitalism; thirty-three percent supported socialism. A later edition of the survey found that fifty-one percent were "fearful about the future," while only twenty percent were hopeful. . . .
>
> Seventy-eight percent of Americans working full time live paycheck to paycheck; nearly half do not have four hundred dollars at the ready. . . .

> . . .while ninety percent of people born in the nineteen-forties outearned their parents – the traditional American expectation – this number has fallen to fifty percent for people born in the nineteen-eighties. [Of course, they could be too young to have done so yet.]

These are the dystopic trends Ocasio-Cortez cites and the source of the resentment of capitalism that gives rise to today's populism from the left.

As I see it, for the 60 years immediately following World War II, much of the world enjoyed a rising tide of prosperity that lifted all boats. That made nearly everyone economically content and thus happy with capitalism and free-market solutions. Even though some people did better than others, most did quite well. Living standards rose and the incidence of poverty declined. Ronald Reagan and Margaret Thatcher celebrated the efficacy of free markets, and the world agreed.

Now the rate of economic progress has receded and current trends are less cheering:

1. The possibility that economic growth will be slower than that of the post-war period
2. The negative impact of globalism and automation on specific groups
3. The increased importance of advanced education or the ownership of capital
4. As a consequence of numbers 2 and 3 above, increased income inequality

In short, the tide is no longer rising to the same extent, and many fewer people are happy with their circumstances and outlook. Their unhappiness crystalizes in populism. And it needs a target. Why not capitalism?

My point here is that, as I said above, I expect the rising influence of the left to impact the 2020 election cycle. Left-wing Democratic candidates will present challenges to moderates in their party, and the latter will have to tailor their messages to compete. And it's starting. In particular, I cite two pieces of proposed legislation that emerged recently from prominent Democrats:

- Senator Elizabeth Warren, already an announced 2020 presidential candidate, has introduced her Accountable Capitalism Act. Two of its provisions caught my attention:

  > . . . incorporation for large companies would become a federal matter, . . . These federally chartered companies would be mandated to consider the interests of a list of stakeholders, from investors to employees to customers and communities. These groups could then sue if they deemed the company had breached their duties. . . .
  >
  > . . . Senator Warren's legislation calls for 40 percent of directors to be elected by employees. (*The Financial Times*, September 24, 2018)

- Senator Cory Booker of New Jersey, often mentioned as a presidential hopeful, has introduced legislation that I view as related:

  > The Worker Dividend Act would mandate that companies buying their own shares must also pay out to their own employees a sum equal to the lesser of either the total value of the buyback or 50 percent of all profits beyond $250 million. (*Vox*, January 10, 2019)

I absolutely am not writing to defend stock buybacks or criticize labor representation on boards. What I oppose is (a) the idea of governments deciding how companies will be run and (b) the appropriation of corporations' economics for parties other than their owners.

What would be the effects of turning over some of businesses' capital to workers, or requiring that they be put on corporate boards? Clearly, to do the former would be comparable to saying to shareholders, "That thing you thought you owned – the company – you don't really own that." Stock buybacks are a way of returning capital to companies' owners. Why should each one be accompanied by giving an equivalent amount to workers? Wouldn't the next step be to say, "Whenever a company pays a dividend, it has to distribute an equal amount to its workers"? **And wouldn't that be tantamount to saying, "As for corporate capital, the workers own half"? Consequences? Ask yourself who would start a corporation in the future if it meant the workers would be entitled to half the gains.**

What about requiring that workers be put on boards? To date, it has been the job of a corporation's directors to represent its shareholders. Requiring that 40% of them be workers would be, in essence, another way of saying the shareholders aren't in full control. If workers were put on boards, whose interests would they represent: the corporation and its shareholders, or labor? To whom would they work to deliver benefits? If an opportunity arose to increase efficiency and profitability by investing in automation, for example, how would labor's directors be expected to vote?

And that leads to the matter of requiring corporations to serve multiple interests. Today, directors are legally deemed to have done their jobs if they applied "business judgment" for the benefit of the company (and thus its shareholders). **How would they be expected to simultaneously work for the good of the company and its owners as well as its workers, customers and communities? Can you imagine the lawsuits that would fly over the issue of whether too much had gone to one group rather than another? How could a court decide whether the multiple constituencies had benefitted in the appropriate proportions?**

What I'd like to do is get some of the progressive politicians and the less-capitalist young people in a room and ask them a simple question: **To what do you attribute America's preeminence in the world over the last hundred years and the generally superior living standards of its people? In short, what has been behind the United States' progress to the top of the heap?**

What's absolutely clear to me is what it's not: that we're superior people, smarter, better, more virtuous or more deserving. Instead, I think it's our democracy, our freedoms, and our less rigid social and financial structures. But, extremely importantly, I also think there have been enormous contributions from capitalism/free enterprise, the free-market system, economic incentives, private ownership of property, individual economic opportunity, and the very limited involvement of government in the economy.

Capitalism is an imperfect economic system, because differential performance in the pursuit of economic success – as well as luck – results in there being (a) some people who are less successful as well as some who are more and (b) a few who are glaringly successful. Obviously I'm someone who has profited from capitalism, so my views could be dismissed as hopelessly biased. However, I'm 100% convinced that the capitalist system has produced the most aggregate gains for our society, exceptional overall progress, and a better life for most. For me, the best assessment of capitalism is the one Winston Churchill applied to democracy:

No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of Government except all those other forms that have been tried from time to time.

In the same way, I'm convinced that capitalism is the worst economic system . . . except for all the rest. No other economy has accomplished what the U.S. has, accompanied by extensive personal freedom, and especially not the ones centrally controlled by government. In particular, no other economy has produced inventions and innovations – and distributed life-enhancing products – like the U.S. has.

I'm not arguing in favor of unfettered behavior on the part of corporations. They can't be allowed to use just any tactics to get ahead. They mustn't be permitted to compete unfairly against each other, behave in anti-social ways, or do damage in pursuit of profit. Thus laws, regulations and active supervision on the part of diligent directors are needed to police corporate behavior. I also think the leaders of society should encourage companies to operate with a conscience and voluntarily work for the betterment of their communities. **But this must be done within the framework of the elements that made America great – not by subverting them.**

Also, I feel it's essential that governments create effective safety nets to assist the less-fortunate members of society who end up at the bottom of the income distribution. Capitalism can make countries successful through the operation of economic incentives and healthy competition, but I'm not in favor of unmitigated "dog eat dog" or "survival of the fittest."

Progressives and Democratic Socialists promise increased equality of income and improvement for people below the top. These are worthy goals, and I support them. But trying to achieve them by dismantling capitalism would be worse for just about everyone. There is no proof that restrictions on capitalism and government involvement in economies can promote equality other than by shrinking the pie. **Consider what it would be like if the U.S. didn't have the sanctity of private ownership, the efficiency of privately run business, and the incentive of personal economic advancement.** The hard-left thinks government can do things better than free markets and increase wellbeing. Which government agencies would you like to see managing our economic engine?

A lot of the left's economic approach is based on closing the income gap, not just by making things better for people at the bottom, but also by pulling down people at the top.

- Thus on the TV show *60 Minutes*, Ocasio-Cortez expressed fondness for a top federal income tax rate of up to 70% on incomes over $10 million. Combined with the top New York State and City rates, for example, that would give government 83% of the marginal income of people in the top bracket. (That's not terribly far from the suggestion from Jean-Luc Mélenchon, the Communist Party's candidate for president of France in 2017, of a 100% tax rate on incomes above €400,000, or 20 times France's average wage.)
- Not dissimilarly, in November members of the House considered adjusting its rules to require a 60% super-majority to increase income taxes on the bottom 80% of Americans, but only a simple majority to raise taxes on the top 20%. Is it fair for government to employ different sets of rules when deciding how different groups will be taxed?

- On January 24, just under the wire for inclusion in this memo, Elizabeth Warren took the issue of differential taxation to its ultimate extreme: a wealth tax. I'll let her words on Twitter speak for themselves:

  > The rich & powerful run Washington. Here's one benefit they wrote for themselves: After making a killing from the economy they've rigged, they don't pay taxes on that accumulated wealth. It's a system that's rigged for the top if I ever saw one.
  >
  > We need structural change. That's why I'm proposing something brand new – an annual tax on the wealth of the richest Americans. I'm calling it the "Ultra-Millionaire Tax" & it applies to that tippy top 0.1% – those with a net worth of over $50M.

  Any populist appeal to resentment there?

  And what exactly is the benefit that the "rich & powerful . . . wrote for themselves"? That they get to keep what they earn net of taxes. **Senator Warren omits to mention that under the American system, <u>nobody</u> pays tax on accumulated wealth. But she sure makes it sound egregious that the rich don't do so.** The rich didn't arrange an exemption for themselves; there is no wealth tax. But why let facts like those get in the way of political rhetoric?

Over the centuries, one thing that has brought successful democracies to an end has been the realization on the part of the majority that they can appropriate more for themselves by taxing those at the top. This is an example of the so-called "tyranny of the majority." As *The New York Times* said the other day, albeit in direct reference to Brexit:

> During debates over the American Constitution, James Madison warned in one of the essays that became the Federalist Papers that unbridled majoritarianism had made earlier democracies "as short in their lives as they have been violent in their deaths." Only "a republic" of representatives subject to rules and institutions as well as the public, he wrote, "promises the cure for which we are seeking."
>
> . . . as Mr. Madison warned in the Federalist Papers, a democracy imposed "by the superior force" of an "overbearing majority" may not always remain democratic. (January 22, 2019)

Does the left understand the long-term consequences of the majority imposing confiscatory taxes on the rich, and do they really want them? Will reducing the incentive to earn more (or incentivizing successful Americans to transfer their citizenship to other nations) really result in the betterment of most people? **Americans generally accept the concept of progressive tax rates. But they must not be punitive and de-motivating.** Note in this regard that in 2015, the top 5% of taxpayers (with 37% of all income) paid 60% of all income taxes, and the top 1% (with 21% of income) paid 39%. To the political left: are those proportions of taxes paid "fair"? And would it still be fair if they were much higher?

(I want to make clear that I believe room does exist for increases in tax rates on the biggest earners since (a) today's top rate of 37% is one of the lowest in the 106-year history of the U.S. income tax and (b) dividends and capital gains are taxed at rates that are far lower still. It could be argued that all forms of income should be taxed the same.)

While there are ways in which the system can be improved, I consider it problematic when people denounce capitalism without acknowledging its benefits. It's ironic to think of politicians criticizing the capitalist system via platforms like Twitter and Facebook (accessed on their iPhones); at rallies reached via airlines and cars (perhaps employing ride-sharing services such as Uber); in meetings over a Starbucks coffee; and via cable news networks. All of these are innovations that came out of a system that encourages people to take significant risks to start companies on the premise that they'll reap the rewards of ownership if their businesses succeed.

I'm sure if they thought about it, the list of innovations these people wouldn't want to live without – ranging from drugs to consumer products, to services, to technology – would be a long one. Which of those would we have today if not for the profit motive and the possibility of ending up with accumulated wealth? And in the absence of those expectations, to whom would we look for the innovations of the future? How's the record of non-capitalist countries such as the U.S.S.R., Cuba and Venezuela in this regard?

A great deal of America's economic progress has resulted from people's aspiration to make more and live better. Take that away and what do we have? The people at the bottom won't have as many at the top to resent. But without the contributions of those who aim for the top, everyone will have less to enjoy (see the appendix for an informative parable). This is why I worry about the rise of negative sentiment toward capitalism and antipathy toward those who succeed under it.

* * *

Politicians, depending on their ideology, can pose simple questions that suggest simple solutions to the problems people face, like these:

- Should we impose tariffs on imports to save American jobs?
- Should workers have a say in how companies are run?
- Should we enact rent control laws to protect tenants from rent increases?
- Should the government provide jobs for all?

For many people, it's easy to answer "yes." The benefits from doing these things are obvious. Who would oppose them?

But it turns out they aren't such easy questions, since economic reality shows them all to have downsides that just might exceed their upsides:

- Should we impose tariffs on imports in order to save American jobs?
  - Do the potential gains for a limited number of workers warrant the broadly shared increase in costs to all consumers?

- Should workers have a say in how companies are run?
  - Will they act in the interests of the companies, society as a whole, or only labor?

- Should we enact rent control laws to protect tenants from rent increases?
    - If rents are regulated, will landlords maintain and expand the stock of rental housing?

- Should the government assure every citizen a job?
    - What incentive will people have to work hard if they're guaranteed employment?

One of the key elements running through economics is its complexity: there are few decisions that face us that aren't multivariate and that are free of second- and third-order consequences. **Thus we shouldn't take actions – like imposing tariffs – just because they offer potential benefits, without considering their costs. And we shouldn't condemn things – like capitalism – solely because they're imperfect, without taking into account their benefits.**

Because economics is just about dollars and consumption, the belief is encouraged that it can be understood intuitively. The truth, however, is that few people are educated regarding economics, and its complexity and ramifications render it far less easy to understand than many people may believe. Yet, while this stuff is complicated, we can all benefit by applying some common sense. You don't have to be an economist to recognize that if you raise the prices of inputs, it increases the cost of goods and reduces the quantity sold, and if you reduce the rewards for success, you'll get less effort to create value.

The bottom line is that politicians are able to offer simple economic solutions that have considerable appeal but fail to hold up in real life. **Since politics is largely about how costs and benefits are distributed – rather than about increasing aggregate benefits – politicians' simplistic economic prescriptions mustn't be swallowed whole.**

January 30, 2019

P.s.: Just prior to publication (I can hardly keep up with the developments in this area!) I received a mass email from a candidate for New York City's Public Advocate, effectively a "public watchdog," stating the following:

> . . . we fought for, and won, a $15 minimum wage, though as we all know, $15 just isn't enough to support a family in this city. So we need to keep fighting. . . . A $30 minimum wage, adjusted with inflation, for New York City government workers and businesses that employ over 75 New Yorkers would be where we start.

This brings to mind the description Winston Churchill used regarding the folly of a nation trying to tax its way to prosperity: "**like a man standing in a bucket and trying to lift himself up by the handle.**"

Appendix: The Tax System Explained in Beer

Suppose that every day, ten men go out for beer, and the bill for all ten comes to $100. If they paid their bill the way we pay our taxes (by taxpayer decile), it would go something like this:

The first four men (the poorest) would pay nothing.
The fifth would pay $1.
The sixth would pay $3.
The seventh would pay $7.
The eighth would pay $12.
The ninth would pay $18.
The tenth man (the richest) would pay $59.

So, that's what they decided to do.

The ten men drank in the bar every day and seemed quite happy with the arrangement, until one day, the owner threw them a curve ball. "Since you're all such good customers," he said, "I'm going to reduce the cost of your daily beer by $20." Drinks for the ten men would now cost just $80.

The group still wanted to pay their bill the way we pay our taxes. So the first four men were unaffected. They would still drink for free. But what about the other six? How could they divide up the $20 windfall so that everyone would get his fair share?

The bar owner suggested that it would be fair to reduce each man's bill by a higher percentage the poorer he was, to follow the principle of the tax system they had been using, and he proceeded to suggest the new lower amounts each should now pay.

And so the fifth man, like the first four, now paid nothing (a 100% saving).
The sixth now paid $2 instead of $3 (a 33% saving).
The seventh now paid $5 instead of $7 (a 29% saving).
The eighth now paid $9 instead of $12 (a 25% saving).
The ninth now paid $14 instead of $18 (a 22% saving).
The tenth now paid $50 instead of $59 (a 15% saving).

The first four continued to drink for free, and the latter six were all better off than before. But, once outside the bar, the men began to compare their savings.

"I only got a dollar out of the $20 saving," declared the fifth man. He pointed to the tenth man, "But he got $9!"

"Yeah, that's right," exclaimed the sixth man. "I only saved a dollar, too. It's unfair that he saved nine times more than me!"

"That's true!" shouted the seventh man. "Why should he get $9 back, when I got only $2? The wealthy get all the breaks!"

"Wait a minute," yelled the first four men in unison, "we didn't get anything at all. This new tax system exploits the poor!"

The nine men surrounded the tenth and beat him up.

The next day, the tenth man didn't show up, so the other nine sat down and had their beers without him. But when it came time to pay the bill, they discovered something important: They didn't have enough money between all of them for even half of the bill!

And that is how our tax system works. The people who already pay the highest taxes will naturally get the most benefit from a tax reduction. **Tax them too much, attack them for being wealthy, and they just may not show up anymore.** In fact, they might start drinking overseas, where the atmosphere is friendlier.

* * *

I've been waiting a long time for a chance to use this. The numbers may not be exactly right, but the idea is. **The unarguable bottom line is that everyone's view of the fairness of the tax system – like most such matters – depends largely on the angle from which you look at it.**

HM

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Memo to: Oaktree Clients

From: Howard Marks

Re: Growing the Pie

A few weeks ago, we were pleased to announce a partnership with Brookfield Asset Management that created an alternative investment manager with one of the broadest slates of strategies and greatest asset totals. And what question did I get? "Will there still be memos?" Well, here's your answer.

* * *

One thing I'm not happy being right about is the tenor of the current debate over our economic system. Most of my January memo, *Political Reality Meets Economic Reality*, was devoted to fretting over the rise of populism from the left and the resulting anti-capitalist sentiment, and it has risen further since.

I mentioned legislation that had been introduced to appropriate some of corporations' cash and governance rights for workers, as well as a proposal for a higher income-tax bracket for top earners. Since then we've seen additional suggestions covering a wealth tax, higher estate taxes and, in New York City, a tax on *pieds-à-terre*. Clearly companies and wealthy individuals are being viewed by some as attractive political targets and good sources of incremental revenue.

One of the main reasons behind populism's ability to stir people is the favorable reception its rhetoric receives. "They have too much." "We've been short-changed." "The system's rigged." "They got where they are by cheating." "The rich don't pay their fair share." **Sound bites like these find receptive audiences among people who are unhappy with their lot, whereas detecting the error in these statements requires an insight, sense of history and understanding of economics that many people lack.**

What's Going On?

In the January memo, I set forth my view that in the last 10-20 years, the rising economic tide had stopped lifting all boats. In addition, major social and economic trends contributed to increases in economic inequality. These developments, I said, were largely behind the rise of populism.

Ray Dalio and Bridgewater actually beat my memo by two days, publishing on January 28 an excellent note titled *Populism + Weakening Economy + Limited Central Bank Power to Ease + Elections = Risky Markets and Risky Economies*. I was particularly drawn to the following passage:

> Disparity in wealth, especially when accompanied by disparity in values, leads to increasing conflict and, in the government, that manifests itself in the form of

> populism of the left and populism of the right. **As a rule, populists of the right (who are usually capitalists) don't know how to divide the pie well, while populists of the left (who are usually socialists) don't know how to grow the pie.** [Emphasis added]

Populism of both the right (behind Donald Trump) and the left (behind Bernie Sanders) played a big part in the 2016 presidential election season. It's the latter that's my subject here.

In my January memo, I argued at length that capitalism can be credited with much of what made the United States what it is today. **In short, to borrow Ray's terminology, the capitalist system achieved this by creating the biggest pie: the largest total GDP in the world and one of the highest per-capita GDPs.** And only capitalism is likely to cause the pie to continue to grow. The failure of non-capitalist systems to produce economic growth and prosperity is well documented.

Obviously, however, when the pie is divided up under capitalism, not everyone gets the same-sized piece. That's the idea underlying the following line in Winston Churchill's speech in the House of Commons on October 22, 1945:

> **The inherent vice of capitalism is the unequal sharing of blessings . . .**

As with so many things, Churchill said it best. Under capitalism we're likely to see bigger slices of the pie go, for example, to those who are smarter, more talented and more hardworking, but also to those who are luckier or born into wealth. The first three of these explanations are generally considered valid, the fourth is not, and people fight about the last. **The gains produced by capitalism are inseparable from – actually they derive from – the opportunity for those who are smarter, more talented and more hardworking to end up with bigger slices of the pie.** On the other hand, no one considers it inherently desirable that lucky people do so also. And many think the benefits of inheritance should at least be watered down (although generally not the benefactors or beneficiaries).

And what do the "populists of the left" want? For the most part, "fairer" and more equal outcomes. They say relatively little about expanding the pie but more about fairness in how it's apportioned. That's why Churchill went on from the above to add:

> **. . . The inherent virtue of Socialism is the equal sharing of miseries.**

When we look around the world, we see countries that have stressed equal sharing of the pie and others that have cared more about expanding the pie. The equal sharers include Cuba, North Korea, Venezuela and the USSR, while the expanders, in addition to the U.S., include South Korea, Hong Kong and Singapore. In which group of countries do people generally live better? In which group would you rather live?

Today, many people apparently fail to understand the role of capitalism in creating the wealth that Americans share. Others may feel the capitalism that got us here may have been fine in its time but isn't needed anymore; thus, we should shift our attention to more equal distribution instead. And a last cohort may consider equal sharing more important than the creation of more prosperity.

Socialism superimposes socio-political considerations on an economic system, such that equality is elevated relative to self-interest and individual motivation. Capitalism omits that emphasis. In this context, last month Charlie Munger called my attention to China's agricultural history following the death of Mao Zedong in 1976. The following excerpts are from a 1986 paper in the *Journal of International Affairs* regarding the then-recent agricultural reforms in China. This'll be a long slog, but I think it's worth studying how China transitioned from the "equal sharing of miseries":

> The long-term (1957-1978) growth of cereal output just kept up with the expansion of the population. Over this period, China actually was becoming more dependent on imported grain to feed its population. . . . By 1978, about 30 million urbanites, roughly 40 percent of the population of China's municipalities, were dependent on imported cereals. The performance of most non-grain crops was even less impressive. . . . The slow growth of farm output, not surprisingly, was accompanied by extraordinarily modest growth of peasant income. . . .
>
> By 1978 an apparent consensus had been reached at the highest levels of the Chinese Communist party that the painfully slow growth of agricultural output was caused . . . by certain inefficiencies of China's collective production structure, the loss of productivity resulting from the promotion of local self-sufficiency, the curtailment of rural marketing and the disincentive of relatively low prices for farm products. Beginning in 1978 the Central Committee endorsed a series of sweeping reforms that addressed each of these problems. Collectivized agriculture . . . was replaced with a system of household farming in which the land was divided among existing households. . . . Decisions on cropping patterns and the quantities of fertilizers and other inputs to be used are now made by each household rather than by team and brigade leaders. . . . Peasants are now encouraged to specialize and produce for the market rather than being forced to be self-sufficient. Comparative advantage cropping has been encouraged by reopening rural markets . . .
>
> These reforms . . . have led to an unprecedented pace of growth since 1978. Grain output, for example, had grown from 305 to 407 million metric tons, an average annual rate of almost 5 percent, well over twice the historic rate of 2.1 percent achieved between 1957 and 1978. . . .
>
> The official jettisoning of the policy of local cereals self-reliance, encapsulated in the Maoist slogan "Take grain as the key link," and the reopening of rural markets have stimulated an upsurge of production of non-cereal crops. . . .
>
> The unprecedented growth of agricultural output also has been accompanied by substantial growth in real farm income. . . . Average per capita farm income in current prices rose from 134 yuan in 1978 to 355 yuan in 1984. . . . The gains derive not only from the growth of farm output . . . but also from the substantial expansion of rural non-farm employment and income. . . .
>
> Although decollectivization has provided the incentives for improved productivity growth, it has created . . . significant and partially unanticipated adverse consequences. . . . Over the longer run it is not clear how the local labor-intensive maintenance of existing irrigation systems will be sustained. . . . The current system appears almost certain to have an adverse effect on the distribution of income in rural areas and may lead, ultimately, to significant rural unrest. . . . Another seemingly

> unanticipated consequence of the demise of the collective system is the impaired delivery of rural social services. State budgetary funds for rural health-care and primary-school education always have been limited. Most of these programs . . . were financed by collectively accumulated welfare funds. . . . A final unanticipated consequence of the reform is its budgetary impact. While the higher farm quota prices the state introduced along with decollectivization have contributed significantly to greater incentives and productivity for peasant producers, the financial burden to the state of these incentives has mounted far more rapidly than expected. [Nicholas R. Lardy, "Agricultural Reforms in China"]

The Chinese experience described above tells the whole story in eight short years: deregulation and decontrol; free enterprise and the profit motive; increased flexibility and choice; the benefits of specialization; and the allocation of resources via the free market. The results: vastly increased production, but also greater inequality and reduced government services. **In other words, you can't have it all. Most people lived much better because of the reforms, whereas under the prior system everyone had it the same, but most people lived far less well. Which was fairer?**

Capitalism doesn't know about or care about fairness in the sense of equal sharing. **What it considers fair is the proposition that people who have greater ability or work harder should be able to earn more.** That potential, it says, provides incentives for hard work and rewards those who achieve, ultimately resulting in a better life for almost everyone. The story of China – just like that of America – shows that it works.

A Case in Point: We Like Our Pie the Way It Is

One of the biggest stories in the business world over the last two years was Amazon's search for a location for another headquarters. A total of 238 cities, towns and other entities submitted proposals, trumpeting their merits as a possible location for HQ2 and, in many cases, offering financial inducements.

The big news came last November, when Long Island City in Queens, New York was chosen for Amazon's expansion, as was Northern Virginia. The parameters in Queens included a $2.5 billion investment on Amazon's part; approximately 25,000 new Amazon jobs (plus the likelihood of thousands more in construction, local infrastructure and support businesses); $27 billion of projected incremental state and city tax revenues over the subsequent 25 years; and $3 billion returned to Amazon over that period in the form of tax credits and subsidies.

The deal's supporters were elated. But opposition soon began to form, and, on February 14, Amazon pulled out.

> The plan fell apart in the face of a backlash over public subsidies, resentment of the covert process in which the city and the state negotiated the deal, and concern about its neighborhood impact. (*The New York Times*, February 22)

Labor unions that would want to organize Amazon's operation opposed the deal because of Amazon's policy of resisting unionization (although, unsurprisingly, the bargain was supported by unions for construction workers and others anticipating expanded work opportunities).

Politics reared its head, of course, especially when the State Senate Majority Leader nominated Michael Gianaris, who represents Long Island City, to the obscure Public Authorities Control Board, which had the power to thwart the project. According to the *New York Post*, Gianaris opposed the subsidies and was "miffed" at not having been consulted by the mayor and governor when the deal was negotiated. Some say his nomination, while never effective, was the nail in the deal's coffin.

Finally, populist rhetoric injected resentment into the process, as per an article in *The New Yorker* magazine of November 17:

> Richard Florida, the urban-studies theorist, told [writer Anand Giridharadas] that Amazon's HQ2 competition "captures the zeitgeist of early 21st century American late capitalism." He added, "The very idea that a trillion-dollar company run by the world's richest man could run an *American Idol* auction on more than two hundred thirty cities across the United States (and Canada and Mexico) to extract data on sites and on incentives, and pick up a handy three billion dollars of taxpayer money in the process, is a sad statement of extreme corporate power in our time" . . .
>
> Alexandria Ocasio-Cortez, the [then-]representative-elect of New York's Fourteenth Congressional District, which spans parts of the Bronx and Queens, criticized the deal on Twitter. "The idea that [Amazon] will receive hundreds of millions of dollars in tax breaks at a time when our subway is crumbling and our communities need MORE investment, not less, is extremely concerning to residents here," she wrote . . .
>
> Reached by telephone on Thursday, Ocasio-Cortez called the Amazon deal "dressed-up trickle-down economics." "What we're seeing here is a complete public cost for a private corporate benefit," she told me. "When you give a three-billion-dollar tax break to the richest company in the world, that means that you're giving up our schools. You're giving up our infrastructure. You're giving up our community development." In other words, there is an opportunity cost to luring the world's richest man by letting him free-ride on the public services that other New Yorkers must pay for.

Although the majority of New Yorkers supported the deal in polls, the combined forces in opposition were sufficient to turn Amazon away. In a statement, the company said:

> For Amazon, the commitment to build a new headquarters requires positive, collaborative relationships with state and local elected officials who will be supportive over the long term.

That doesn't sound unreasonable.

But Amazon's decision not to go forward was cause for victory celebrations on the left. City Councilman Jimmy Von Bramer said:

> Even when we were faced with the richest man in the world and the richest company in the world, we did not buckle. Amazon doesn't need our $3 billion . . . (*New York Post*, February 15)

And Rep. Ocasio-Cortez tweeted the following:

> Anything is possible: today was the day a group of dedicated, everyday New Yorkers & their neighbors defeated Amazon's corporate greed, its worker exploitation, and the power of the richest man in the world.

In other words, the response from the "progressive" left was that Amazon could take those jobs and shove them.

I don't mean to single out Ocasio-Cortez, and I have nothing against her. But she is the most prominent spokesperson for the approach that so troubles me, and what she says exemplifies that which I want to resist. Here's what *The Washington Post* (owned by Amazon's Jeff Bezos) said in a February 21 article titled "Alexandria Ocasio-Cortez is an economic illiterate — and that's a danger to America":

> Case in point: Last week, Ocasio-Cortez celebrated the tanking of the deal negotiated by her fellow Democrats in which Amazon promised to build a new headquarters in Long Island City, New York, right next to her congressional district. Amazon's departure cost the city between 25,000 and 40,000 new jobs. Forget the tech workers whom Amazon would have employed. Gone are all the unionized construction jobs to build the headquarters, as well as thousands of jobs created by all the small businesses — restaurants, bodegas, dry cleaners and food carts — that were preparing to open or expand to serve Amazon employees. They are devastated by Amazon's withdrawal.
>
> Ocasio-Cortez was not disturbed at all. "We were subsidizing those jobs," she said. "**Frankly, if we were willing to give away $3 billion for this deal, we could invest those $3 billion in our district, ourselves, if we wanted to. We could hire out more teachers. We can fix our subways**. We can put a lot of people to work for that amount of money if we wanted to." [Emphasis added]

She entirely misses the point. **There was no $3 billion sitting in a city bank account, waiting to be spent on either subsidies for Amazon or enhanced services for New Yorkers. The $3 billion going to Amazon wouldn't have represented a diversion of resources from other potential uses.** It consisted entirely of contingent future payments: the part that would be kicked back to Amazon from the taxes it would pay, the balance of which could be used to support infrastructure or services. **No Amazon, no $3 billion paid out** (and no $24 billion of net taxes received by the city and state). Ocasio-Cortez either (a) completely misunderstood the deal she was criticizing or (b) overlooked the facts in favor of rhetoric calculated to play on resentment and scare up votes. Which explanation would you consider preferable?

A lot of readers enjoyed the story in my January memo about the ten men who drank beer in a bar every night, with each paying according to his ability. (It was included as an appendix. Nancy missed it the first time through; I hope you didn't.) When the grateful bar owner took 20% off their collective tab, the ten disagreed over how the reduction should be divided up, since most of it appeared likely to go to the richest man (who'd been paying most of the bill). In their anger, the other nine men beat up the tenth. He didn't come back after that, leaving the nine unable to afford their daily beer. **They sure showed him!**

And likewise, New York showed Amazon! They beat Amazon up, and it's not coming back. If you look back at the politicians' statements above, you'll see they're all about resentment of Amazon's (and Bezos's) wealth and how unwarranted the subsidies were. But there was no mention of the lost potential jobs or what's good for New York's economy or, more importantly, for its people. New York had a great chance to expand the pie, and the populists of the left found a way to scuttle it.

Another example of channeling resentment toward the rich is the *pied-à-terre* tax that's been proposed in New York City. The tax was inspired by a money manager's purchase of a $238 million apartment as a second (or possibly third) home. It would impose a levy on houses and apartments worth more than $5 million that aren't primary residences, on the grounds that the owners benefit from their homes' New York location without paying New York income tax. But is it smart?

Absentee owners pay real estate tax even though they use few city services. And when they come to town, their spending contributes to the economy. Do they really abuse the city? And the new tax would exacerbate the current glut of high-end homes by turning away some of the potential purchasers for whom they were built. *The New York Times* (March 24) says ". . . the tax is one small way to make New York City a little fairer." It also mentions the political palatability of a tax on wealthy absentee owners. But given that the obvious effect will be to depress the market for homes and diminish employment in a broad range of related industries, does it make economic sense?

The rhetoric of the far left plays on resentments and differences, and it's easily swallowed. But the policies are more likely to equalize the sharing of misery than to expand blessings, however unequal.

* * *

About 50 years ago, an older friend described for me what he felt made America great:

> When the worker in Britain sees the boss drive out of the factory in his Rolls Royce, he says, "I'd like to put a bomb under that car." But when the worker in the U.S. sees the boss drive out of the factory in his Cadillac, he says, "Someday I'll own a car like that."

Today, too few Americans feel they might own that Cadillac. Taken to the logical extreme, that has the potential to bring the American miracle to an end. **Thus, business should do all it can to arrest the trend toward stagnant and unequal incomes . . . not just to be fair or generous, but to assure perpetuation of the system that got us here.**

Capitalism is the most dependable route to prosperity. And it has to be responsible capitalism. **The solution can't lie in turning away the Amazons of the world, imposing extra taxes on Cadillacs or otherwise shrinking the pie.**

April 1, 2019

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Memo to: Oaktree Clients

From: Howard Marks

Re: This Time It's Different

I first came across the title of this memo in an article titled "Why This Market Cycle Isn't Different" by Anise C. Wallace in *The New York Times* of October 11, 1987. It went as follows:

> The four most dangerous words in investing are "this time it's different," according to John Templeton, the highly regarded 74-year-old mutual fund manager. At stock market tops and bottoms, investors invariably use this rationale to justify their emotion-driven decisions.
>
> Over the next year, many investors are likely to repeat these four words as they defend higher stock prices. But they should treat them with the same consideration they give "the check is in the mail. . . ."
>
> Nevertheless, in the bull market's sixth year, the "this time it's different" chorus is beginning to be heard. Wall Street professionals predict that, before the bull market ends, individual investors, who have mostly stayed on the sidelines, will be swept along in the mania characterizing a market peak.
>
> They will invest in stocks despite the fact that the Dow Jones Industrial average has more than tripled in the last five years. They will be hearing overwhelmingly compelling reasons why stock prices should go higher, why the bull market should last considerably longer than any other in history, why this boom will not be followed by a 1929-like crash and why "this time it's different."
>
> Many of these arguments will be tempting because they will have some element of truth to them. Even Mr. Templeton concedes that when people say things are different, 20 percent of the time they are right. But the danger lies in thinking that the different factor – like the recent investment in United States stocks by the Japanese – will be uninterrupted.

Wallace's essential message is that investors must take heed when the four words are in widespread use. Why? Look back at the paragraph introducing the above quote: when you first read it, did you happen to notice the date of publication? **It was just eight days before Black Monday (October 19, 1987), the worst day in stock market history.** We know how bad it feels when the market falls 20% in a year. Try 22% in a day!! Wallace's warning was particularly important at the time the article was published, but for me it's always important.

*   *   *

Typically in investing, historical norms put limits on asset prices. Thus, for example, bull markets can generally go to extremes only if investors discard the notion that the p/e ratio on the S&P 500 stock index shouldn't go much above its post-World War II average of 15 or 16. If the earnings of the S&P's underlying companies grow at 10% a year, by definition the index can rise 20% a year (as it did in the 1990s) only if the ratio of price to earnings is viewed as highly expandable. It was such a perspective that allowed the index to reach 32 times earnings at the start of this century (with highly negative implications for equity returns in 2000-02).

Think of a rocket launched from Cape Canaveral. Gravity has to be overcome in order for it to escape the earth's atmosphere. Likewise, the limitations imposed by past norms have to be overcome in order for asset prices to slip their historic moorings and blast off into outer space.

Today we're not hearing much about historic valuations being irrelevant, as they're not terribly high. **Instead, what we're told is different this time is the relevance of restrictions on future economic and market performance:**

- There doesn't have to be a recession.
- Continuous quantitative easing can lead to permanent prosperity.
- Federal deficits can grow substantially larger without becoming problematic.
- National debt isn't worrisome.
- We can have economic strength without inflation.
- Interest rates can remain "lower for longer."
- The inverted yield curve needn't have negative implications.
- Companies and stocks can thrive even in the absence of profits.
- Growth investing can continue to outperform value investing in perpetuity.

I rarely participate in a meeting these days without someone asking about one or more of these propositions. **The bottom line is that for any of the nine to be true, things really have to be different this time.** I'll discuss the outlook for each below.

<u>The avoidable recession</u> – The questions I get most often these days are "Is the U.S. heading for a recession?" and "When will it start?" My answer to the first is a simple "yes." (At least I can never be proved wrong.) We've always had economic cycles, and I believe we always will. Eventually, favorable developments will lead people to engage in behavior premised on excessively optimistic assumptions, and eventually the over-optimism of those assumptions will be exposed and the excesses will correct in a period of negative growth. Moreover, even economies that aren't marked by excesses are subject to exogenous shocks.

When people ask about the coming recession, what they mostly mean is "Might it be a long way off?" Well, the longest U.S. recovery on record lasted ten years, and the current one is in the twelfth month of its tenth year. There's no reason a recovery can't go beyond ten years; no gate will come down on June 30, foreclosing further progress. And it's important to note that since this has been the most sluggish U.S. recovery since World War II, it hasn't been characterized by excesses to the upside, meaning there needn't be a recessionary correction on the usual schedule.

Very soon, the current recovery is bound to become the longest in U.S. history. However, I believe the odds are that it's closer to the end than the beginning. (We never know for sure what's going to happen in the future. At best we can think in terms of the probabilities. That's the thinking behind my latest book's subtitle: *Getting the Odds on Your Side*.) The recovery is likely to go on longer, but perhaps not much longer. Still, I wouldn't place a wager on when it will end.

About a year and a half ago, following the enactment of President Trump's stimulative tax cuts, people started to ask me whether the U.S. might emulate Australia, whose last recession was in 1990. While not quite the same as asking "might there never be another recession?" the idea of 28 years between recessions would represent a radical difference this time.

My answer to the above question is "probably not," since there are significant differences between the two countries that probably render Australia's example inapplicable to the U.S.:

- A much bigger part of Australia's GDP is based on exporting natural resources such as iron ore and coal, of which it has so much. Thus in recent decades it has drafted off the unusually strong growth of its much larger neighbor to the north, China.
- In addition, ". . . having a conservative, domestically focused, highly concentrated banking system meant that Australia wasn't stuck importing other countries' financial contagions when crises hit." (*The New York Times*, April 7, 2019)
- In fact, I see in Australia a conservatism and discipline capable of extending financial good times without creating excesses. My favorite example is the Australia Future Fund, which the government formed in 2006 to deal with the country's pension liabilities, with funding that came from fiscal surpluses (!) and the privatization of Telstra, the formerly state-owned telecommunications company. The fund's assets, now standing at A$154 billion, were essentially put into a lockbox until 2020, which now appears likely to extend until at least 2026. What's the likelihood that U.S. politicians would (a) fund government pension obligations up front, rather than deal with them on a pay-as-you-go basis, and (b) keep their hands off the assets for 20 years, rather than use them to pay for constituent-pleasing spending increases or tax cuts?

So no, I don't think the U.S. is about to emulate Australia's 28-years-and-counting recovery. That I will bet on.

<u>Perpetual prosperity from quantitative easing</u> – In the aftermath of the Global Financial Crisis, the Fed engaged in quantitative easing, a program of purchasing bonds in the open market. The effect of the Fed's purchases was to (a) inject bank reserves into the financial system, (b) strengthen the demand for bonds, thereby bringing down long-term interest rates (which are unaffected by the Fed's normal open market operations related to short-term rates), and (c) with prospective returns on high-quality bonds brought down, reignite risk-bearing on the part of investors seeking higher returns, thereby causing the credit window to reopen. QE was a success in the U.S., and the economy recovered. Thus some people are now proposing that the Fed could engage in QE forever, with similarly positive results.

First, I think some part of the impact of QE may be psychological. In other words, QE stimulates the economy in part because people accept that QE is stimulative. If the Fed took exactly the same actions but did so without making an announcement, would the effect be the same? (I believe there's a self-fulfilling, placebo-like component to many of the Fed's tactics.) In this regard, I think its first round of QE was more effective than its second, and its second round was more effective than its third. Accordingly, there could be a diminishing return from permanent QE, as the psychological effect abates.

And who knows exactly how QE works? Last week, at a conference I attended, a participant suggested that under Modern Monetary Theory (see more below), the Treasury could issue a potentially unlimited amount of debt, and if third-party buyers failed to take it up, the Fed could buy it under QE. Does this seem reasonable? If the Fed credits banks with reserves, the banks lend a multiple of those reserves, and the borrowers use the loan proceeds to make purchases or investments, does the process really inject money into the economy, or is it mostly a matter of bookkeeping? Or are they one and the same? Of course, this question is relevant to all nations with fiat currencies.

Quantitative easing is generally considered to have contributed to the past decade's low prospective investment returns, resultant risk-taking, asset inflation, and increasing wealth divide. As with any other prescription, shouldn't we worry about possible side effects like these?

Can government actions permanently raise the level of demand in an economy, or do they mostly accelerate future demand into the present? If the latter, can QE elevate GDP forever above what it otherwise would have been? I doubt it. But if it could, wouldn't that eventually cause what I call an "excess," leading to a recession?

Finally, when I hear people talk about the possibility that the Fed will prevent a recession, I wonder whether it's even desirable for it to have that goal. Per the above, are recessions really avoidable or merely postponable? And if the latter, is it better for them to occur naturally or be postponed unnaturally? **Might efforts to postpone them create undue faith in the power and intentions of the Fed, and thus a return of moral hazard? And if the Fed wards off a series of little recessions, mightn't that just mean that, when the ability to keep doing so reaches its limit, the one that finally arrives will be a doozy?**

Benign federal deficits – Over the years, some in government have pursued balanced federal budgets, or at least have paid them lip service. Democrats have generally been described as wanting to "tax and spend" in order to do more for citizens. But they've sometimes spent before they've taxed. Republicans, on the other hand, have positioned themselves as the party of fiscal restraint. It's often been their official position that there could be no increases in spending if not accompanied by corresponding increases in funding.

Regardless of the debate, federal budgets are rarely tendered on time or in balance these days. We've had deficits in 46 of the last 50 years (with the exception of 1998-2001), and in recent years they've risen as a percentage of GDP despite the prosperity we've been enjoying. Often there isn't even a pretense of interest in fighting deficits. Democrats have big spending ideas even in the absence of ways to fund them. And Republicans cut taxes but not always spending.

Both parties now seem to feel that the way to win elections is to simply ignore deficits. In the 1930s, John Maynard Keynes said that in periods when private economic activity isn't generating enough demand to create full employment, governments should spend more than they take in, counting on deficit spending to stimulate demand. And then, during the resulting periods of growth, they should spend less than they take in, using the surplus to pay down the debt that was taken on to fund deficits. But departing from this, at the end of 2017, in the ninth year of a recovery, the Republicans enacted sweeping tax-rate cuts capable of ballooning the deficit.

A new entrant in this area is receiving a lot of attention: Modern Monetary Theory ("MMT"). One of its components is the belief that government deficits currently are too small, and in any event not a bad thing:

> Tax revenues are not what finance the government's expenditures, argues Stephanie Kelton, an economist at Stony Brook University and one of the most influential modern monetary theorists. What actually happens in a country that controls its own currency, she says, is that the government first decides what it's going to spend. In the United States, Congress agrees on a budget. Then government agencies start handing out dollars to the public to pay for those tanks, earth movers and salaries. Afterward, it takes a portion back in the form of taxes. If the government takes back less than it gave out, there will be a deficit. . . .
>
> Ms. Kelton . . . points out that every dollar the government spends translates into a dollar of income for someone else. So a deficit in the public sector simultaneously produces a surplus outside the government. . . . (*The New York Times*, April 7, 2019)

Thus, according to MMT, deficits are benign – not a sign of profligacy – and merely an indication that the government has put more money into the economy than it has taken out in taxes. MMT is modern in that it has moved past the old-fashioned concept of balancing spending and revenues, opening the door for bigger deficits.

Does Ms. Kelton think deficits don't matter? No, the *Times* article goes on:

> Of course they matter, she said. . . . They can be too big, especially if they are not used to increase the nation's productive capacity, or if there is a shortage of labor, raw materials and factories.

In this connection, we should note that Ms. Kelton served as an economic adviser to Bernie Sanders in 2016. Thus it may be reasonable to suspect that MMT is largely a rationale for governments to give away more free stuff, expanding their deficits. **Sometimes it can be hard to separate economic opinions from political leanings.**

This relaxed view of deficits reminds me of a hypothetical consumer who has a credit card with no credit limit. He can spend whatever he wants without having to worry about paying off the balance. In theory, this could work (although it's challenging to figure out what's in it for the card issuer). But at a minimum it doesn't allow for unforeseen developments. **I believe here, as elsewhere, the workings of economics are too uncertain for a perpetual motion machine like MMT to be relied upon. In other words, Modern Monetary Theory is just that: a theory. What if it's wrong?**

> . . . when the University of Chicago's Booth School of Business asked top scholars about a couple of [MMT's] claims, they split between the 28 percent who disagreed and the 72 percent who strongly disagreed. (ibid.)

Disregarded national debt – I recall a heated debate when I was young over whether it's okay for nations to permanently be in debt. More recently, any such doubt has been forgotten, and almost all nations are debtors. The main issue became whether there can be a level of debt that's too high. But now, thanks to MMT, there's a belief that there's no such thing.

Continuing from the *Times*'s description of Modern Monetary Theory:

> "The national debt is nothing more than a historical record of all of the dollars that were spent into the economy and not taxed back, and are currently being saved in the form of Treasury securities," Ms. Kelton said.

In other words, national debt is just a sign of all the government has accomplished.

While I can't prove that Modern Monetary Theory is off the beam, I also can't see making it the economic law of the land. Does it have a weakness? I think there may be one hidden in the middle of the long quote above, regarding **"a country that controls its own currency."** I don't know exactly what Ms. Kelton meant by this phrase, but it might be a reference to a country that can print as much money as it wants without having to worry about its currency depreciating, and thus one that is always able to issue and refinance debt without limits.

Today the U.S. dollar is the world's reserve currency, and there aren't any obvious candidates to replace it. Further, the U.S. benefits from an unlimited appetite for its debt, since it's the safest of any major sovereign. For these reasons, expanding the national debt isn't a problem. And like the cardholder described above, since there's no limit to its credit, the U.S. can add the interest that accrues to the unpaid balance.

What happens if these conditions change? Could a tipping point be reached at which there's so much debt that people question the U.S.'s creditworthiness and ability to repay its borrowings? In that case, the demanded interest rate would rise, meaning the debt and interest mightn't be repayable without massive money printing that would result in debasement of the dollar. Thus, could there come a day when it takes unacceptably more purchasing power to pay off U.S. debt denominated in dollars that have depreciated?

I put these questions to my friend Randy Kroszner, former member of the Fed's Board of Governors and Deputy Dean at the University of Chicago's Booth School of Business. Here's his response:

> I think the last three decades for Japan and the last decade for the U.S. have shown (and continue to be showing) that countries with credible institutions can "get away with" higher debt levels without a raid by bond vigilantes than most had once thought. That said, it leaves the country vulnerable to a change in sentiment, exactly as you describe. "Getting away with it" for too long erodes the credibility of the institutions over time.

Again, MMT might work, and vastly expanded national debt might prove viable or even advantageous. But I wouldn't bet the ranch on it.

Economic strength without inflation – For the last 60 years, there has been widespread (albeit not universal) acceptance of the so-called Phillips curve, which posits an inverse relationship between the rate of unemployment and the rate of inflation. In other words, as unemployment falls and the labor market tightens, workers gain bargaining power and employers have to compete for a declining number of available workers. This results in rising wages, which translates into increasing inflation.

The U.S. has seen unusually little unemployment during the Trump presidency, and today it's at a 50-year low. Nevertheless, there hasn't been much wage inflation until very recently, and there still isn't much general inflation.

There are reasons why the relationship underlying the Phillips curve as defined above might be different from what it was in the past:

- Since the U.S. labor force participation rate (percentage of adults who are either employed or looking for work) is at its lowest level in more than 40 years, it might be more meaningful to look at the non-employment rate (the percentage of adults who aren't working) rather than the unemployment rate (the percentage of adults looking for work who aren't working). By the former measure, the labor market isn't so tight.
- Inflation might be structurally lower now and in the future than it was in the past, altering its relationship to conditions in the labor market. Automation, the shift of manufacturing to low-cost countries and the prevalence of free/cheap stuff in the digital age might help explain today's unusually low rate of inflation. For examples of the third of these, think about recent trends in the price of photographs, cellphone calls, messages (texts and emails versus telegrams and faxes) and books.
- On the other hand, the cheapening of things like those listed just above could halt, and a more traditional relationship between inflation and unemployment could resume.

Excessive inflation creates a number of serious economic and social problems, typically requiring central banks to raise interest rates to cool it off, with the effect of dampening economic growth and job creation. Likewise, rising inflation can cause investors to demand higher interest rates on bonds and loans to compensate for the risk of losing purchasing power. This can make it harder for borrowers to service their debt, causing defaults to rise and discouraging investors from taking risk and providing financing. (On the other hand, there's a level of inflation that's desired such that, among other things, workers will see wage growth, and the U.S. can repay outstanding debt with dollars representing a reduced amount of purchasing power. Today that desired rate is about 2%, and policymakers worry about the fact that it hasn't materialized despite the low unemployment rate.)

Rising inflation could be seen as a potential contributor to the end of the recovery. So far it hasn't shown up despite the tightness of the labor market. Has the Phillips curve relationship been revoked for good, or is inflation in the offing? Who knows?

The word I use to describe inflation is "mysterious." It's rarely clear how it gets started, and in the 1970s and early '80s, when it reached the mid-teens in the U.S., no one could figure out how to stop it until after Paul Volcker became Fed chair. It's mysterious why there's so little inflation today, and whether there'll be inflation in the future. But I'm not confident that it'll still be below 2% a few years from now.

Persistently low interest rates – "Lower for longer" has been another rallying cry of the bull market. If interest rates remain low, economic growth is encouraged, defaults are scarce, risk-taking is encouraged and financing is easy. So far – against the odds – the strength of the U.S. economy hasn't caused interest rates to rise.

The Fed has raised interest rates nine times since the end of 2015, taking the short-term fed funds rate from roughly zero to 2¼-2½%, and in late 2018 it said it would go further. But in January, in response to fears of economic weakness that arose in 4Q2018, the Fed reversed course and declared that there would be no more increases for now. Whereas the yield on the 10-year Treasury note hitting 3¼% early last October coincided with (and probably contributed to) the start of the stock market's fourth-quarter swoon, the promise of low rates has played a big part in the rally this year.

In mid-2007, in a real economy that felt to me a lot like this one, the fed funds rate and the yield on the 10-year Treasury note both were around 5¼%. Today, with the fed funds rate and 10-year Treasury yield below 2½% instead, the Fed describes interest rates as "neutral": neither low enough to be stimulative nor high enough to be restrictive. (I considered the 2007 rates to be neutral – how can that be true of rates at both levels?)

Will the Fed leave rates low? Can it do so if inflation strengthens? Will it leave rates so low that there's little room to reduce them in the future should stimulus be needed? If deficits and debt grow faster than GDP, won't that put upward pressure on interest rates? Or if the Fed cuts rates, as many people now consider likely, will the markets be cheered by the stimulus, or will they fall in response to the economic concerns at which the rate cuts are directed? Certainly no one can say.

Equanimity regarding the inverted yield curve – Something else we've heard a lot about over the last couple of years is how risky it is when the yield curve inverts.

The yield curve is usually upward-sloping, meaning lenders demand higher interest rates when they lend for longer periods as compensation for the increased uncertainty (especially with regard to possible declines in the purchasing power of the currency between the time the loan is made and when it's repaid). But sometimes, long-term rates fall below short-term rates, and the curve is said to be "inverted." The curve has been unusually flat in recent months, and today it's actually inverted.

Because most periods of inversion have been associated with recessions, the condition is considered worrisome. In that regard, the *Financial Times* noted on June 1 that "the [yield curve] has 'inverted' before every US recession in 50 years." (Note, however, that this is different from saying every inversion has been followed by a recession.) What people should be focusing on isn't the usual coincidence of inversions and recessions, but rather the reason for this particular inversion. Understanding the latter might allow observers to sense whether a recession is implied and avoid a "false positive."

The explanation for inversions isn't always clear, since interest rates (like inflation) can be mysterious. Today I would say the inversion of the curve may be due to the fact that the Fed has brought short rates up at the same time that (a) there's a surplus of capital for investment at the long end of the yield curve, putting downward pressure on rates there, and (b) there's less reliance on capital investment in the information age, so less demand for long-term debt capital. One more thing that may be bringing down long-term yields is an increase in general worry among investors, and thus a flight to the safety of Treasurys. When demand for bonds rises, sellers are able to require buyers to pay higher prices, which translate into lower yields.

I don't fully understand why an inverted yield curve should be a negative, but its fans swear that it is. I merely can't prove that it's not. One possible ramification is the threat to bank profitability: an inverted yield curve takes away banks' ability to make money simply by borrowing short to lend long.

<u>Profitless success</u> – Historically, companies have been considered valuable primarily because they produce profits – if not immediately, then at least they were expected to do so in the foreseeable future. Then the view arose in the tech-media-telecom bubble of the late 1990s that companies could be great (and valuable) even in the absence of profits for years to come. Today, profitless companies are back in vogue and sometimes valued in the tens of billions of dollars.

Tech and venture investors have made a lot of money over the last ten years. Thus there's great interest in tech companies (including ones like Uber and Lyft that are applying technology to enable new business models) and willingness to pay high prices today for the possibility of profits far down the road. **There's nothing wrong with this, as long as the possibility is real, not over-rated and not over-priced.** The issue for me is that in a period when profitless-ness isn't an impediment to investor affection – when projected tech-company profitability commencing years from now is valued as highly as, or higher than, the current profits of more mundane firms – investing in these companies can be a big mistake.

Today there are a lot of investors who weren't around to see the 2000 bursting of the TMT bubble, in which large numbers of Internet and e-commerce companies were given the benefit of the doubt, only to end up worthless. Venture capital funds showed triple-digit annual returns in the late 1990s, but the ones started around 2000 performed very poorly (and people began to ask me if venture capital was a legitimate asset class).

Today, some tech and venture investments have again produced great results, and the doubts seem to be gone. **In investing, however, the truth usually lies somewhere between the extremes of infinite value and worthlessness.** Investor sentiment seems to be closer to the positive end of the pendulum's arc these days, but it's unlikely to stay there in perpetuity.

<u>Growth investing preeminence forever</u> – Since future-oriented "growth investing" has been so successful for so long, and has so seriously trounced "value investing," people are asking me whether this will ever end. In particular, value investing is being likened to the out-of-favor "cigar-butt" school of investing, in which people buy assets regardless of their quality just because they're low-priced. Critics of value investing argue that, since the technological leadership that's often associated with growth stocks is so essential for success in today's world, old-economy companies lacking it are unlikely to be top performers in the future.

My answer is simple: low price is very different from good value, and those who pursue low price above all else can easily fall into "value traps." And certainly it's true that old-economy companies are less likely to be the fast growers of the future or benefit as much from the "moats" that protected them in the past.

It may also be true that given the ease today of searching the universe of securities, it may be harder than it used to be to find "value" companies with current assets or earning power that are broadly unrecognized and thus underpriced. Since the best returns come from buying things whose merits others aren't aware of, it's certainly possible that easy, widespread access to data is making it harder for value investors to excel.

On the other hand, companies that do have better technology, better earnings prospects and the ability to be disrupters rather than disrupted still aren't worth infinity. Thus it's possible for them to become overpriced and dangerous as investments, <u>even as they succeed as businesses</u> (this was often the case with the Nifty-Fifty in 1968-73). And I continue to believe that eventually, after the modern winners have been lauded (and bid up) to excess, there will come a time when companies lacking the same advantages will be so relatively cheap that they can represent better investments (see value versus growth in 2000-02).

Understandably, the stocks of companies with bright futures are likely to be outperformers in times of economic growth and optimism, when investors are happy to pay up for potential. But stocks of companies with tangible value in the here-and-now are likely to hold up better in less positive times because (a) they've previously been disrespected and valued lower and (b) the rationale underlying their prices is less a matter of conjecture and faith. Thus a swing in favor of value may have to await a period in which the "champions" lose some of their luster, perhaps in a market correction (see 4Q2018). But it'll come.

*   *   *

What do all the theories propounded above have in common? That's easy: they're optimistic. Each one provides an explanation of why things should go well in the future, in ways that didn't always go well in the past.

In recent years, the U.S. has simultaneously experienced economic growth, low inflation, expanding deficits and debt, low interest rates and rising financial markets. **It's important to recognize that these things are essentially incompatible. They generally haven't co-existed historically, and it's not prudent to assume they will do so in the future.**

Many of the beliefs discussed above suggest we're in a so-called "Goldilocks" environment: one that's not too hot and not too cold.

- Economic growth won't be so strong that it brings on excessively high inflation, or so weak that it ends in recession.
- Inflation won't be so low that the economy stagnates, or so high that it leads to burdensome increases in the cost of living and requires contractionary interest-rate increases to cool it off.

I've seen times in the past when people believed such an ideal state would continue in perpetuity, but it has never worked out that way. Maybe it will this time – no one can prove it won't until it doesn't

– but certainly broad acceptance of such a proposition indicates that optimism prevails in the current investment environment.

We keep an eye out for the widespread belief that "this time it's different" because we want to know if markets are being lifted by bullishness, optimism, risk tolerance and low levels of skepticism. **Everything else being equal, these things result in asset prices that are high relative to intrinsic values, and their presence exposes us to the risk that they'll abate, taking asset prices down with them.**

In *On the Couch* (February 2016) I said:

> **That's one of the crazy things: in the real world, things generally fluctuate between "pretty good" and "not so hot." But in the world of investing, perception often swings from "flawless" to "hopeless."** The pendulum careens from one extreme to the other, spending almost no time at "the happy medium" and rather little in the range of reasonableness.

Widespread attaching of "the four words" to bullish propositions suggests that the environment is being perceived as flawless. When and if that swings to hopeless, the result is pain for investors.

Of course, no one can prove that the nine propositions discussed above won't hold. Economics and markets aren't governed by immutable laws like the physical sciences, and there's no schematic diagram that shows how they work. Thus, I want as usual to make it explicit that these are the musings of someone who (a) isn't an economist and (b) doesn't claim to know exactly how economic and monetary mechanisms function. **But who does?**

Now, sometimes things really are different, as Templeton said. (And in areas like technology and digital business models, I'd bet things will be different more than the 20% of the time Templeton cited.) Certainly the world today is very different from that of the past. As I've written before, 40 years ago it felt like the world was a stable place that was subject only to limited change in areas like scientific progress, fads and politics. Today the idea of an unchanging world is out the window: things change every minute, and anyone who doesn't keep up with the changes is fated to miss out. Technological prowess can be essential for success, and every company or industry that lacks it is susceptible to being disrupted by those who possess it.

I readily admit that, at my stage in life, I may not fully grasp the forces that will determine the future. At times like this, when tech stocks are in the middle of a great run, I'm reminded of a classic book from my youth, *The Money Game* (1967). In it, the pseudonymous Adam Smith introduced the Great Winfield, a veteran broker who, despite the limitations associated with having reached middle age, was minting money in the new tech stocks. When asked about the source of his success, he introduced Smith to his traders:

> "My boy," said the Great Winfield over the phone, "Our trouble is that we are too old for this market. The best players in this kind of a market have not passed their twenty-ninth birthdays."

> . . . "My solution to the current market," the Great Winfield said. "Kids. This is a kids' market. This is Billy the Kid, Johnny the Kid, and Sheldon the Kid."
>
> . . . "See? See?" said the Great Winfield. "The flow of the seasons! Life begins again! It's marvelous! It's like having a son! My boys! My kids!"

Of course, veteran that he was, the Great Winfield knew the truth. Thus he went on:

> **. . . "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," said the Great Winfield. "Now you know and I know that one day the orchestra will stop playing and the wind will rattle through the broken window panes . . ."** [Emphasis added]

To close, I'll return to a concept I consider indispensable for anyone hoping to succeed at investing – the three stages of a bull market:

- the first, when only a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone concludes that things can only get better forever.

Clearly the few who buy in the first stage – when optimism is scarce and thus asset prices are low – can access great bargains. But those who buy in the last stage – out of a belief that the news will always be good – can be making a big mistake. **The nine propositions reviewed above all represent variations on "things can only get better forever." If they're the ideas guiding investors today, that should be considered worrisome.**

The best investments often are made in times of fear and desperation. That's rarely possible when investors are willing to blithely dismiss the limitations of the past with the words "this time it's different." I would remind those investors of a quote usually attributed to Mark Twain: "History doesn't repeat itself, but it does rhyme." **Of course it's important that investors keep up with current developments and those that will shape the future. But it's also essential that they not completely unlearn the lessons of the past.**

June 12, 2019

Legal Information and Disclosures

Memo to: Oaktree Clients

From: Howard Marks

Re: On the Other Hand

It often happens that just as I'm about to release a memo, I come across something that absolutely has to be incorporated. That was the case on June 12, the day "This Time It's Different" was published. I was reading a first-quarter report from Ruffer, a London-based money manager, and I came across the following question:

> Can the Fed, with its discretions and its firepower, keep a market dislocation at bay, or halt it once it has begun?

That question caused me to think back to remarks made a few days earlier by Federal Reserve Chairman Jerome Powell regarding how the Fed would deal with the possibility of a trade war and its potential ramifications:

> We are closely monitoring the implications of these developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2% objective. (CNBC, June 4)

Together, these two inputs prompted me to reflect on the role and powers of the Fed. **In short, is it the Fed's job to sustain expansions and keep market dislocations at bay *ad infinitum*?** I concluded that "This Time It's Different" shouldn't ignore this subject and, as a result, reworked the end of its section on quantitative easing, adding a new final paragraph:

> Can government actions permanently raise the level of demand in an economy, or do they mostly accelerate future demand into the present? If the latter, can QE elevate GDP forever above what it otherwise would have been? I doubt it. But if it could, wouldn't that eventually cause what I call an "excess," leading to a recession?
>
> **Finally, when I hear people talk about the possibility that the Fed will prevent a recession, I wonder whether it's even desirable for it to have that goal.** Per the above, are recessions really avoidable or merely postponable? And if the latter, is it better for them to occur naturally or be postponed unnaturally? **Might efforts to postpone them create undue faith in the power and intentions of the Fed, and thus a return of moral hazard? And if the Fed wards off a series of little recessions, mightn't that just mean that, when the ability to keep doing so reaches its limit, the one that finally arrives will be a doozy?**

I'm so glad these last-minute inspirations caused me to include the above. I think the topic is very important, so much so that I'm now going to devote a memo to the subject of Fed interest-rate management.

What Do Fed Actions Tell Us?

Many people look at the operation of an economy and the efforts of a central bank to influence it and see things that are logical and straightforward. Others see a complex ecosystem that has financial, political and behavioral components, with tendencies that are understandable but certainly subject to significant uncertainty and ambiguity. I'm one of the latter. I think of the Fed and its considerations as complex, multi-faceted and characterized by a great deal of on-the-one-hand-but-on-the-other-hand. I'll explain at length below, right after issuing my usual caveats: I'm not an economist, an expert on monetary policy or a Fed watcher – just a casual observer.

Many people take Fed actions at face value. **When the Fed cuts interest rates, as the consensus expects it to do soon, investors take that as a "buy" signal. Their thought process is simple: weak economy → rate cuts → economic stimulus → stronger GDP → higher corporate profits → higher stock prices.** For this reason, many people – first-level thinkers that they are – take a statement like Powell's above as simplistic and a positive.

But there's much more to the story. Digging deeper, one should ask, "Why is the Fed cutting rates?" The answer, of course, is that the Fed anticipates economic weakness (or sees it taking place) and wants to ward it off. So the second-level thinker wonders how bad the outlook is, how much worse it might have gotten without the rate cut, and whether the cut will be sufficient to avert a slowdown.

In 2006, on the way to the Global Financial Crisis, delinquencies on sub-prime mortgages began to rise. The trend became more noticeable in mid-2007, leading to falling prices for mortgage-backed securities; margin calls for mortgage-backed-securities funds (from banks that had given them leverage); and, eventually, fund meltdowns. Most prominently, on July 31, 2007, two mortgage-backed-securities funds managed by Bear Stearns filed for bankruptcy.

Investors wanted help, and the Fed rode to the rescue. On September 18, it cut the fed funds rate by 50 basis points, from 5.25% to 4.75%, and issued a statement that included the following:

> Today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time. . . .
>
> Developments in financial markets since the Committee's last regular meeting have increased the uncertainty surrounding the economic outlook. The Committee will continue to assess the effects of these and other developments on economic prospects and will act as needed to foster price stability and sustainable economic growth.

The rate cut and message were warmly received, with the S&P 500 rising more than 6% over the next two weeks. Few people, I think, questioned whether this really was good news.

Shortly after that first cut, I considered the following question: If you went to the doctor for an ailment and he pulled out a huge hypodermic needle, would you take that as good news or bad? Since the vast majority of Fed actions consist of 25-basis-point interest rate cuts or increases, doesn't a cut of 50 basis points mean the Fed finds the outlook particularly worrisome? If a rate cut of 25 basis points is good news for the markets, is a cut of 50 basis points better or worse?

My point is that a rate cut's implications aren't always as simple a matter as they may appear to be. Assuming the Fed is a good diagnostician, a decision to cut rates isn't necessarily good news. You can argue that, if there's trouble ahead, we're better off with a rate cut than without one. **But that still doesn't make it good news. First, it means the Fed thinks trouble is looming. And second, it certainly doesn't guarantee the problem will be solved.** (It's worth noting that 18 months after that first rate cut in September 2007 – during which time ten more cuts followed, eventually taking the fed funds rate to nearly zero – the S&P 500 finally bottomed out, **down more than 50% from where it stood on the day of the first cut**.)

Are Low Interest Rates a Good Thing?

The Fed's decision early this year to depart from its announced program of rate increases is widely recognized as a main contributor – if not the main contributor – to investors' decision to stop pushing down the markets through selling, as well as to the rally indicated by the S&P 500's gain of roughly 20% so far this year. Since then the rally has been propelled by the expectation of rate cuts, and by statements like Powell's on page one.

This is the case because of the widespread general faith in the progression I laid out above: weak economy → rate cuts → economic stimulus → stronger GDP → higher corporate profits → higher stock prices. But how, exactly, do low rates contribute to wealth creation?

- Low interest rates encourage spending on the part of consumers. Low rates reduce the cost of borrowing, lifting demand for things that are often bought on time or leased, like cars, homes and appliances. Further, low rates translate into lower monthly payments on floating-rate mortgages, leaving consumers more disposable income to spend. Finally, with rates low, spending instead of saving entails little in the way of opportunity costs.
- Low rates likewise encourage investment on the part of businesses by reducing the cost of capital, and therefore the return hurdle for expenditures.
- Increased demand for goods and services leads to increased hiring, reduced unemployment and a tighter labor market, and thus to wage inflation. Rising wages encourage consumer spending by putting more money into wage-earners' pockets and improving their mood.
- By reducing the interest expense on companies' floating-rate debt, low rates enhance companies' profits; make it easier for them to service their debt; and leave them more cash for capital expenditures (which add to GDP), and dividends and stock buy-backs (which put money in investors' pockets).
- **Low rates reduce the discount factor used in calculating the net present value of future cash flows. Thus, all else being equal, there's a direct connection between declining interest rates and rising asset prices. (I consider this to have been the dominant feature of the world of finance over the last ten years.)**
- Low rates on savings and fixed-income investments drive investors to accept increased risk in order to pursue decent returns in a low-return world. This increased risk tolerance makes the financial markets more accommodating, increasing the availability of financing for ventures that otherwise might find capital in short supply.
- Finally, rate cuts are taken as a predictor of further rate cuts, implying more of all the above. **When they're moving in a positive direction, the things described above contribute to the appearance of a virtuous circle.**

For these reasons, most market participants (a) would rather have low rates than high rates and (b) seem to believe that the lower rates are, the better. At this point in time, the U.S. is led by a great cheerleader for low rates. In fact, Powell's 2018 decision to continue his predecessor's rate increases and quantitative tightening earned him a place on the list of people experiencing President Trump's wrath. Here are a few indications of the esteem in which Trump holds Powell:

> My biggest threat is the Fed. Because the Fed is raising rates too fast, and it's independent, so I don't speak to him, but I'm not happy with what he's doing. (Trump, speaking to Fox Business Network, October 16, 2018)
>
> "Here's a guy, nobody ever heard of before, and now I made him and he wants to show how tough he is? O.K. Let him show how tough he is," Mr. Trump said on Wednesday. "He's not doing a good job."
>
> . . . "We should have [European Central Bank head] Draghi, instead of our Fed person," Mr. Trump said. "Draghi, last week, he said lower interest rates and we're going to stimulate the economy. They're going to put money into the economy."
>
> . . . Those comments came after Mr. Trump on Monday accused the Fed of botching the job. "Now they stick, like a stubborn child, when we need rate cuts and easing, to make up for what other countries are doing against us. Blew it!" Mr. Trump said on Twitter. (*The New York Times*, June 26)

Why would Trump want lower rates? Here are a few possible explanations:

- He's a real estate guy, and the real estate industry lives on high leverage.
- Trump has been a substantial borrower for much of his life, so for him low rates are "all good."
- Right now Trump is tightly focused on getting reelected, and ensuring economic growth and a rising stock market over the next 16 months is one of the best things he can do to make that a reality.
- Along those lines, if reelection is his main goal, he may be relatively indifferent as to what happens after Election Day 2020, when the scorecard he cares about most will be closed out.

Here's an expression of Trump's position on rates:

> "Our country's doing unbelievably well economically," he told reporters Friday. Yet even as Mr. Trump celebrated the robust hiring numbers, he called again for the Federal Reserve to cut interest rates – a step that would ordinarily suggest worries about the economy's direction. Growth "would be like a rocket ship" if the Fed acted, he declared. (*The New York Times*, July 6)

On the basis of the above, one might conclude that Trump thinks rates should always be low. But there was at least one instance when he thought rates were being held too low:

> In late 2015 then-candidate Donald Trump accused Janet Yellen, chair of the Federal Reserve, of being part of a political conspiracy. Yellen, he insisted, was keeping

interest rates unjustifiably low in an attempt to help Hillary Clinton win the presidency. (*The New York Times*, June 20)

Regardless, it's clear that, at this time, Trump thinks low rates are good and there's no reason to worry about potential negative ramifications. But that doesn't mean they don't exist.

Is There a Downside to Low Interest Rates?

The truth is, there are ways in which low rates are undesirable and potentially harmful. They include these:

- Low rates stimulate the economy, as described above, and most economists and businesspeople believe there's such a thing as the economy becoming too hot. **The principal worry is excessive inflation.** While some inflation is a good thing, too much isn't. It's generally accepted that too much of the positives described on page three can lead to excessive demand for goods and services; too-tight labor conditions, leading to excessive wage inflation; too much market power in the hands of sellers of goods; and thus rising prices.
- Too much inflation imposes a hardship on people living on fixed incomes, since their costs increase rapidly while their incomes don't. Also, low-income households typically don't have the means to hedge against inflation that high-income ones do, such as through investments in equities and real assets.
- When low rates penalize savers by reducing the returns available on safe instruments like cash, money market funds, savings accounts, Treasury securities and high grade bonds, savers' alternative to accepting lower incomes is to assume increased risk in pursuit of the higher returns they used to earn safely.
- Thus low rates can lead to investment in undeserving companies and shaky securities, encourage the use of excessive leverage, and create asset bubbles that eventually can burst.
- Ultimately, investors' tendency to reach for yield and assume excessive risk can introduce risk to overall financial stability.
- **Finally, but very importantly, when interest rates are low, central banks don't have at their disposal as much of their best tool for stimulating economies: the ability to cut rates.**

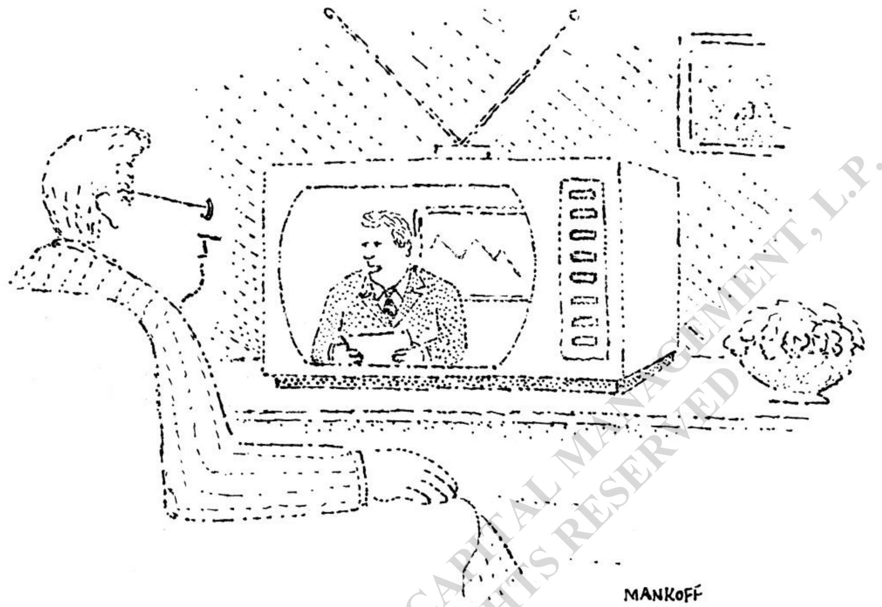
The following is from a report from RDQ Economics dated June 27:

> What seems lost in the policy assessment is a careful discussion of the risks of overly accommodative monetary policy. Powell did say this week, "we are also mindful that monetary policy should not overreact to any individual data point or short-term swing in sentiment. Doing so would risk adding even more uncertainty to the outlook." However, our view is that Powell's observation of the downside of a dovish overreaction is an inadequate assessment of the risk from unnecessarily adding monetary accommodation at this time.
>
> . . . underlying inflation is already close to target and the Fed's past attempts (in the late 1960s/early 1970s) to trade off a little more inflation for sustained lower rates of unemployment turned out very badly. Alternatively, higher labor costs from an

overheated jobs market might squeeze company profit margins and lead to a pullback in investment and hiring.

A Daunting Task

The juxtaposition of the above lists of positives and negatives shows that low interest rates – just like most other aspects of economics – have both pros and cons. A lot depends on how they're viewed. This is illustrated by one of the greatest cartoons from my collection:



"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."

That cartoon is 38 years old. Here's how *The Times* put it as recently as a couple of weeks ago:

> The gains this week began after Federal Reserve chair, Jerome Powell, suggested the nation's central bank was worried about the economy. Just days earlier, strong data on the job market had the opposite effect on stocks.
>
> This counterintuitive reaction to the news is a phenomenon that's explained by expectations for interest rates. The weakening outlook for the economy means, in all likelihood, borrowing costs are coming down — and in the right circumstances, this can be good for stocks. (*The New York Times*, July 12)

Many people think of an economy as a dependable machine that operates according to diagrams and rules, and of central bank actions as levers that can be pulled to adjust the functioning of that machine. But, instead, I believe a lot of uncertainty and variability exist regarding the functioning of economies and central banks. This means the task of managing an economy is difficult, and its goals shouldn't be thought of as dependably achievable.

I think a recent article from *The Times* provides a great picture of how challenging the job is, and how many ways there are to be wrong. Here's most of it:

> Heading into their policy decision and news conference Wednesday [June 19], there were a lot of ways Federal Reserve officials could have messed things up.
>
> **One possibility** was a repeat of the meeting in December, when markets judged Chairman Jerome Powell and the Fed to be oblivious about negative forces building in the markets and in the global economy, and sold off precipitously over the next days.
>
> But **the opposite risk** was present as well — that out of fear of repeating the December episode, Mr. Powell would exhibit too much of a hair-trigger reaction to recent signs of a slowdown in inflation pressures and industrial activity. If those turn out to be false alarms, a rate cut now would be counterproductive by signaling pessimism and making the Fed look jittery and perhaps even overly influenced by President Trump's threats to try to demote Mr. Powell over interest rate policy. . . .
>
> In effect, Fed officials are indicating they think it's pretty likely they will need to cut rates, but are waiting for more evidence.
>
> The relatively muted reaction of financial markets suggests that Wall Street viewed the move [i.e., no change in rates on June 19 but foreshadowing likely cuts later in the year] as appropriately balanced. The stock market was up, but only a little, which helps reduce the sense the Fed is just acting to prop up stocks, while bond yields fell further as markets became more confident that rate cuts were on the way.
>
> So in terms of the narrow goal of getting through Wednesday without either markets falling apart or the Fed's credibility being shredded, it was a good day for Mr. Powell.
>
> But **the flip side** of that is that some lingering questions have been put off to another day.
>
> Deciding to wait for more evidence is a decision, too. Waiting might buy the Fed more time to make sure it's getting the decision right, but at the cost of losing the opportunity to show it is aggressive and willing to get ahead of a potentially serious problem.
>
> Put differently, if you wait until there is completely compelling evidence of an economic shift before doing something about it, you're probably too late.
>
> **On the other hand**, if the Fed later judges that the recent bad news really was just a temporary blip and that rate cuts were actually not needed, they will face the reality of rate cuts even more baked into the prices of Treasury bonds. It would be a doozy of an adjustment to bring them into alignment. If the sharp drop in rates that has

> taken place since November were to reverse quickly, it could cause huge damage to interest-sensitive sectors like housing and automobiles. ("The Fed Threads the Needle, for Now," June 21 – emphasis added)

In other words, there's the risk of being unresponsive or over-responsive, along with the risk of doing too much or too little, and of doing it too soon or too late.

The Fed usually acts in response to the overall outlook for the economy: hundreds of millions of transactions entered into by Americans each day. But among the "developments" Powell said the Fed is monitoring today are some very specific, largely political actions. In particular, the Fed has to anticipate and cope with the possibility of a trade war, probably the greatest source of economic uncertainty today. It has to make interest rate and quantitative easing decisions based on its judgment as to what Trump will do (and its impact). Not to mention the lingering risk that Powell's job hangs in the balance if the answer isn't low rates. Certainly little of this can be thought of as scientific or reliable.

Further, the Fed has to practice psychology:

> . . . Mr. Powell was asked at the news conference about academic research suggesting that when interest rates are near zero, a central bank actually should be more aggressive, rather than less, about cutting rates in the event of a slump — **to maintain credibility that it will not let deflation take hold**.

In "This Time It's Different," I expressed my view that one of the reasons interest rate adjustments work is that it's commonly accepted that they will work. When a rate cut is announced, people take it on faith that it will cause the economy to strengthen and markets to rise. Thus they conclude it's appropriate to spend more and invest more, and their resulting behavior produces the desired response in the economy and markets. Do the lower rates cause the rise, or is it belief in the efficacy of rate cuts? Both, I'd say. But certainly the latter's contribution isn't insignificant. As I asked in "This Time," would a rate cut have the same impact if it weren't accompanied by an announcement? **Clearly, prevailing opinion regarding Fed management matters a great deal in the efficacy of its actions.**

Not only does the Fed have to figure out what actions it should take to keep the economic machine humming, but also whether people will react positively and trust in them to work. In other words, psychology, not just economics.

> [Powell] acknowledged the idea behind that [academic] work, saying that "an ounce of prevention is worth a pound of cure," but declined to connect it to what exactly the Fed might do in the current circumstance. "I don't know what that means in terms of the size of a particular rate cut going forward," he said.
>
> So did the Fed get it right Wednesday with the balanced, nuanced approach Mr. Powell chose? The answer is: Ask in a few months.

* * *

So what's the bottom line? **On one hand, our economy is still expanding.** Monetary stimulus via rate cuts (just like fiscal stimulus via deficit spending) is in order when the economy is weak and failing to create jobs. **But stimulus may be somewhere between unneeded and counter-productive at times like today, when the economy is growing acceptably, the unemployment rate is at a 50-year low, wages are rising, and the recovery has just become the longest in history.** As I said when the Trump tax cut was enacted in December 2017, doctors don't prescribe adrenaline for healthy patients. The economy today is healthy. But the Fed has to worry about whether it will remain so, and in particular whether there will be a full-fledged trade war with China.

Thus, on the other hand, people are concerned about the potential for economic weakness. Recent market reaction suggests investors are following their usual elementary take: weak economy → rate cuts → economic stimulus → stronger GDP → higher corporate profits → higher stock prices. When Powell indicated on July 10 that a rate cut could be more imminent than most had thought, the market sat up and saluted, taking the S&P 500 above 3,000 for the first time. **It's always worth considering whether investors are reacting too positively to the prospect of rate cuts and paying too little heed to the economic weakness on which they're predicated (and the potential unintended consequences they might bring on).**

Thus, on the "third hand," I want to return to the paragraph I included above from "This Time It's Different":

> **Finally, when I hear people talk about the possibility that the Fed will prevent a recession, I wonder whether it's even desirable for it to have that goal.** Per the above, are recessions really avoidable or merely postponable? And if the latter, is it better for them to occur naturally or be postponed unnaturally? **Might efforts to postpone them create undue faith in the power and intentions of the Fed, and thus a return of moral hazard? And if the Fed wards off a series of little recessions, mightn't that just mean that, when the ability to keep doing so reaches its limit, the one that finally arrives will be a doozy?**

Should we be happy to see the Fed trying to prolong the economic expansion and the bull market when they're already the longest in history? Should it try to produce perpetual prosperity and permanently ward off a correction? Are there risks in its trying to do so? It all depends on which hand is doing the weighing.

July 26, 2019

Legal Information and Disclosures

Memo to: Oaktree Clients

From: Howard Marks

Re: Mysterious

Most of the time, my memos have their origin in something interesting that's happening in the world or in a series of events I come across that I think can be interestingly juxtaposed. This one arises from a less usual source: a request.

The other day, my colleague Ian Schapiro, the leader of Oaktree's Power Opportunities and Infrastructure groups, suggested I write a memo about negative interest rates. My reaction was immediate and unequivocal: **"I can't. I don't know anything about them." And then I realized that's the point. No one does.** But Ian thinks I can make a contribution, so I'll try. I've been saving up clippings on this subject, as you'll see. Ian's urging set me to work.

* * *

For a good while now, I've used the term "mysterious" in connection with inflation (and deflation). What causes rapid inflation? How can it be stopped? Economists offer explanations and prescriptions regarding each occurrence, but they rarely apply the next time.

And that brings us to the subject of negative interest rates. I find them no less mysterious. **The fact that we know what they are** – as we do with inflation and deflation – **doesn't alter the fact that we don't know for sure why negative rates are prevalent today, how long they'll continue in force, what might cause them to turn positive, what their consequences are, or whether they'll reach the U.S.**

<u>No, I'll Pay You!</u>

Historically – until the European Central Bank took the rate on its credit facility to -0.10% in 2014 – borrowers paid interest to the people from whom they borrowed money. But in the recovery from the Global Financial Crisis, interest rates went negative for the first time in recent history, meaning some lenders paid borrowers for the privilege of lending them money.

I had my first direct brush with negative interest rates in 2014, when I was making an investment in Spain. The closing was due to take place on Monday, and I wired funds on the prior Wednesday so as to be in position to close. The following conversation ensued with my Spanish lawyer:

> Carlos: The money has arrived. What should I do with it between now and Monday?
>
> HM: Put it in the bank.

> Carlos: You know that means you'll get less out on Monday than you put in today.
>
> HM: Okay, then don't put it in the bank.
>
> Carlos: You have to put it in the bank.
>
> HM: So put it in the bank.

That's it in a nutshell. Money can't be free-floating in space. It has to be someplace. And you can't keep much of it in your wallet or under the mattress. Thus, in general, any substantial sum has to go into the bank. And in Europe – then and now – doing so means you'll get out less than you put in.

I have to admit that this didn't come as a shock to me. Oaktree and I had turned very cautious in 2005-06, and as a result, all of my money that wasn't in Oaktree funds was in a "laddered portfolio" of U.S. Treasurys. (In my case, equal amounts of 1, 2, 3, 4, 5 and 6-year maturities. When the closest-in note matures, you roll it to the end of the line. It's the most mindless form of investing known to man.)

At the time I put that portfolio together, I signed up for a yield in the range of 5-6%. And I was thrilled: the greatest safety, total liquidity and a meaningful yield. But then, in 2007, the Fed started cutting rates to rescue the economy from the sub-prime mortgage crisis. And one day in late 2008, my banker called to say, "The 6% note has matured. You can roll it over at five-eighths." I asked, "What-and-five-eighths?" "No, that's it," he said, "just five-eighths."

The world had changed. **Up until the Global Financial Crisis, we could store money with the government and be well paid to do so. But now my reaction was, "given the level of fear in the financial world, maybe one of these days people will end up paying to store their money safely."**

In the period 2008-14, Europe experienced the Global Financial Crisis, a European debt crisis (with concern over the solvency of "peripheral" nations on Europe's southern tier), and rapidly escalating prices for commodity raw materials. In response, the European Central Bank and some non-EU countries moved to adopt negative interest rates. Here's how it goes:

> Commercial banks usually earn interest on the extra reserves they keep with central banks, like the Fed or the European Central Bank. Negative policy interest rates force them to pay to keep money in those accounts, a penalty aimed at pushing them to lend more and goose the economy. (*The New York Times*, September 9)

Central banks determine short-term base rates ("policy rates") as described above. That establishes the origin of the yield curve, and rates/yields on other types of short-term debt, as well as longer-term instruments, can be expected to respond by moving to a logical relationship with the base rate. Eventually, negative interest rates paid on bank deposits should be reflected in negative yields on bonds. (Note: for the most part, negative rates are applied today only to large deposits. Small depositors have thus far been spared.)

Today, large numbers of bonds – the vast majority being government bonds from Europe and Japan – carry negative yields to maturity. They constitute roughly two-thirds of the bonds in Europe and 25-30% of all the investment grade debt in the world. A few corporate bonds also offer negative yields, however, and there's even a handful of negative-rate high yield bonds (the ultimate oxymoron).

Further, on September 4 *Bloomberg* pointed out the prevalence of negative real rates:

> While over $17 trillion of the global stock of debt trades at nominal yields below zero, the figure jumps to $35.7 trillion when inflation is taken into account. . . . In the U.S., more than $9 trillion of the nation's government debt carries yields lower than the CPI rate.

With a negative-rate instrument, the price you pay for a bond today exceeds the sum of the face amount that will be repaid when it matures plus the interest you'll receive in the interim. That means if you buy a negative-yield bond and hold it to maturity, you're guaranteed to lose money. Why, then, would anyone want to buy a negative-yield bond? Here are some reasons that make sense:

- Fear regarding the future (relating to recession, market declines, credit crisis or further declines in interest rates, among other factors) that causes investors to engage in a **flight to safety**, in which they elect to lock in a sure but limited loss.
- A belief that interest rates will go even more negative, giving holders a profit, as it implies bonds will appreciate in price (as they would with any decline in rates).
- An expectation of deflation, causing the purchasing power of the repaid principal to rise.
- Speculation that the currency underlying the bond will appreciate by more than the negative interest rate.

The concept behind negative rates is simple. It's merely the reverse of the traditional norm, in which lenders receive interest from borrowers. Generally speaking, interest rates are a function of two variables: (a) the time value of money and (b) expected changes in the purchasing power of money (i.e., inflationary or deflationary expectations). (Of course, interest rates should also incorporate a risk premium to compensate for any credit risk entailed.) If, for example, lenders want a 2% annual real return to compensate for the time value of money and expect 2% inflation over the next five years, a five-year Treasury note should yield 4%. But if lenders expect deflation at 3% per year, that note should theoretically yield *negative* 1%.

Are today's negative rates in Europe and Japan telling us deflation lies ahead? Or have lenders changed their views regarding the time value of money? Or are rates negative simply because governments and central banks want them to be?

<u>Reasons for Negative Rates</u>

Here are some of the reasons I've come up with for negative interest rates, some I've read about, and some my friends have suggested:

- The obvious one: **central banks in Europe and Japan want rates to be negative to stimulate their economies**. (They want to supply more stimulus than had been afforded by the reduction of rates to near-zero, since that level of stimulus didn't prove up to the task.)
- ". . . central banks around the world are racing to cut interest rates in an effort to stay ahead of the Fed and support their economies by weakening their currencies." (*The Wall Street Journal*, August 12)
- Ongoing quantitative easing – central banks' bond purchases – is pushing up the price of longer-dated bonds, and thus pushing their yields down into negative territory.
- Quantitative easing means the central banks flood the financial system with money that needs investing. Since borrowers don't have much demand for long-term capital, they won't pay to use it. Thus holders have to pay a small fee to store that money.
- **Fearful investors have little interest in making investments that represent bets on their countries' economies and companies.** They certainly don't want to borrow for that purpose.
- Current economic weakness reinforces investors' pessimism. **Fear of increasing weakness in the future strengthens their desire for safe storage.**
- There's so much money in the system that the excess of supply over demand drives down the price of money – borrowing rates – into negative territory. "In today's global economy, private investment demand is manifestly unable to absorb private savings . . ." (Lawrence Summers, *Financial Times*, October 12)
- Unfavorable demographic trends mean central banks can't maintain positive rates without curbing growth.
- The lack of inflation means investors needn't demand protection against the loss of purchasing power over time. The wonders of technology may continue to make products available cheap or free, capping inflation.
- Fear of deflation adds further to the willingness to invest without such protection.
- "The rise of businesses dealing in intangible products has rendered the economy less capital-intensive . . ." said *Grant's Interest Rate Observer* on July 26. This reduces the demand for long-term borrowings.
- **Certain regulations require financial institutions to invest in home-country sovereign bonds regardless of the yield they offer (and whether it's positive).** This artificially lifts the demand for (and thus the prices of) those bonds.

Everyone has favorites from this list. But everyone differs, including the "experts." Some people think we have negative rates because central bankers want them, some think it's because the market sets them, and some think it's some of each. "Did interest rates fall, or were they pushed?" asks *Grant's*. Given all the above, no one should feel the reasons for negative rates are fully understood.

<u>The Impact of Negative Rates</u>

A quote attributed to Albert Einstein in various forms is relevant to this discussion.

> Compound interest is the 8th wonder of the world. He who understands it, earns it; he who doesn't, pays it. (*RateCity*)

Under compound interest, by not withdrawing interest as it is earned, not only does an investor earn interest on his principal year after year (as with simple interest), but each year he also earns interest on the interest that was earned in the preceding years. Thus principal can grow powerfully if left invested for a long period. (At 10%, $100 grows to $300 in 20 years under simple interest, but to $673 if allowed to compound.) What a wonder!

There's one problem, however. The miracle of compound interest works in reverse if the interest rate is negative, making Einstein wrong about its virtue. Who would want to reinvest income at negative rates? And where would income come from for that purpose?

It's not just Einstein's observation that may be rendered invalid. Negative rates turn a lot of the usual processes upside down. Here are several examples:

- Negative rates make life more difficult in a TINA ("there is no alternative") world. Many investors don't want to knowingly sign on for negative rates. **That makes risky investments preferable, even if they promise historically low prospective returns. In this way, risk aversion is discouraged. "I have no choice but to go into risky assets, because I can't accept a negative return on safe ones."**

  > There is clear evidence that this is happening among institutional investors. The flow of pension fund money into any asset that promises to beat zero-rate bonds has been so dramatic that equities, junk bonds, property, private equity and a host of other more abstruse areas of investment have spiraled in value – and to such an extent that they look highly vulnerable to any shock . . ." (*Financial Times*, August 5)

  Proof? What about the fact that in early July, a €3 billion offering of Italian sovereign bonds maturing in 2067(!) was almost six times oversubscribed thanks to its lavish 2.877% yield? What a bonanza Italy was at the time, with a 10-year bond out-yielding Germany's 10-year by 215 basis points, 1.78% to -0.37%.
- There's no longer any reason to pay slowly in order to make money on "float."
  - In the old days, people paid their bills on the last possible day, preferring to keep the money in the bank and earn interest as long as possible. Under negative rates they may prefer to pay sooner.
  - Many insurers traditionally have made money primarily because they paid claims years after they collected the premiums on the policies they issued. What happens if it costs them money to hold float until claims are paid?
- Likewise, there's no impetus to collect receivables quickly. In the past, wholesale customers were offered discounts for paying bills early. Now the seller might say, "No, you keep it. I'd rather you paid me in six months."
- Negative rates put pressure on people, such as retirees, who live on the income from their investments.

- **Importantly, the pessimistic signals sent by negative rates may mean they have a contractionary rather than stimulative effect.**

> Research has suggested that Japan's negative rate policies may have backfired, actually lowering inflation expectations instead of firming them, as hoped. (*The New York Times*, September 11)
>
> Last week famously blunt ING boss Ralph Hamers excelled himself, all but calling the ECB idiotic for planning to shift rates further downwards. "The negative rate environment is making consumers so uncertain about their financial environment that they're starting to save more rather than less," he said.
>
> Mr. Hamers has a point. Rather than encouraging people to borrow and spend, the data suggests nervous eurozone consumers are hoarding. Eurostat reports the eurozone household savings ratio is at a five-year high of nearly 13 per cent. (*Financial Times*, August 5)

- If interest rates for small savers ever were to go negative, it would give rise to the juxtaposition of income penalties for households with benefits for "the elites" through their ability to profit from rising equity prices. **Economic impact aside, the boost to populist politics would likely be dramatic.**
- Negative rates can distort the workings of floating-rate financial products. Lenders and depositors might have been happy in the past receiving interest rates at a spread over the base rate Euribor. With a negative base rate, however, loans and deposits might leave them with less money than they anticipated as time passes.
- Negative rates on U.S. Treasurys would, for example, harm the Social Security Fund (which can only invest in Treasurys), hastening the day when it runs out of money.
- **Negative rates can warp the calculation of discounted present values.** In particular, when the discount rate is negative, the present value of future pension obligations can exceed their future value. The combination of high discounted obligations and low yields on investments can be disastrous for the funded status of pension funds.
- **Ditto for the impact on bank profitability.** Negative rates charged to borrowers can sap the returns banks depend on, throwing countries' banking systems into reverse. Already, some banks have seen the need to issue mortgages with negative interest rates. "In a negative rate environment, the bank must pay to hold loans and securities. In other words, banks would be punished for providing credit . . ." (Jim Bianco on *Bloomberg*, September 3) "Certainly Europe's bankers are squealing, as they feel margins squeezed by low rates on lending and a reluctance to pass on negative rates to depositors." (*Financial Times*, August 5) Big banks can charge negative rates to corporate and HNW depositors, but as I mentioned earlier, thus far retail banks haven't passed them on to small savers. Doing so could cause those savers to leave the banking system, depriving it of a traditional source of deposits.
- What about the application of negative interest rates to corporate bonds? How will the markets value businesses that hold cash versus those that are deep in debt? Traditionally,

markets have penalized heavily levered companies and rewarded those that are cash-rich. But if having negative-yield debt outstanding becomes a source of income, will levered companies be considered more creditworthy? Conversely, how will the market value businesses that hold a lot of cash and thus have to pay banks to keep it on deposit?

- **Financial models and algorithms – which essentially are a matter of looking for and profiting from deviations from historic relationships – may not work as well as they did in the past**, since history (all of which has been based on positive interest rates) may be out the window.

> Nobel prizes have been awarded to economists that developed concepts such as the efficient frontier, the Capital Asset Pricing Model and the Black-Scholes option pricing model. But when a negative value is assumed for the risk-free rate in these types of models, fair value results shoot off toward infinity. With trillions of securities and derivatives dependent on these models, valuation is critical. (Jim Bianco, *op. cit.*)

The one thing we can't be sure of is that negative rates increase economic growth (or produce more growth than is generated by low rates). First, this requires "what-if" analysis, which is one of the most difficult kinds: are Europe and Japan growing faster today than they would have if their rates weren't negative? And second, you surely can't look at their current growth and pronounce negative rates a huge success. Are negative rates stimulating demand, or are they a matter of "pushing on a string," powerless to convince pessimistic consumers to spend?

In the financial world, most of our actions are based on the assumption that the future will be a lot like the past. Positive interest rates and the desirability of compounding have been among the most fundamental historical building blocks.

> If negative rates become more widespread across the globe, then the financial system needs to be rebuilt on a new set of assumptions. The problem is that we do not yet know what those should be or how they would work. (Jim Bianco, *op. cit.*)

At minimum, negative rates mean there's increased uncertainty, and thus we have to proceed with more trepidation. Whatever we knew in the past about how things worked, I think we know less when rates are negative.

Will the U.S. See Negative Interest Rates?

As stated above, the vast majority of today's negative-yield bonds are in Europe and Japan. One of the biggest questions surrounds whether negative rates will reach the U.S.

This question takes me back to my immediate response to Ian's suggestion that I write this memo: **nobody knows, and certainly not me.** When something hasn't happened in the past, it's impossible to be sure you know how it'll end up. **Different people will express opinions on**

this subject with differing degrees of confidence. Yet I remain certain that none of them "know."

If I had to take a guess – and that's all it would be – I'd say interest rates won't go negative in the U.S. in the current cycle. If we go back to the possible reasons for them listed on page four, I think we'll conclude that the factors at play in the U.S. make negative rates less likely:

- Stronger current economic growth
- Better growth prospects
- Thus no need for emergency measures
- Higher inflation expectations (especially given the tightness of the labor supply)
- Less pessimism
- Better uses for long-term capital

So I don't think current conditions in the U.S. call for negative rates. But that doesn't rule them out. When you express an opinion, the real question is whether you'll bet on it and whether you'll give odds. I might put up $60 to win $50 from you if negative rates don't materialize. But that's not a sign of much confidence on my part.

In particular, I wonder about monetary stimulus. The U.S. fed funds rate is below 2% as I write, thanks to the two recent rate cuts (and there might be another cut on the way soon). Yet most stimulus programs have entailed rate cuts totaling several percent. So there's every possibility that in the future, the Fed's response to economic weakness could take rates into negative territory.

And the current slowdown in U.S. manufacturing – plus the uncertainty brought on by the on-again/off-again prospect of an escalating trade war with China – raises the possibility of a recession, and thus the need for stimulus through rate-cutting.

Some argue that strong demand for safe assets and negative demographic trends apply in the U.S. also, and thus U.S. bond yields can fall below zero.

Finally, negative rates abroad strengthen demand for dollars so foreigners can invest at the positive U.S. yields, causing the dollar to appreciate. Thus the Fed may have to lower rates to keep the foreign-currency cost of U.S. exports from rising too much, and thus their competitiveness from declining and our economy from weakening. **How long can the Fed maintain rates that are much higher than those in the rest of the world?**

Maybe I should reconsider my offer of 6-to-5 in favor of rates staying positive . . .

What, Then, Is There to Do?

I'm convinced that no one should be categorical about how to deal with a mystery like this in such unprecedented and confusing circumstances. But the *Financial Times* of August 5 advanced one idea that seems perfectly logical:

> For SFr1,000 a year, your typical Swiss private bank will give you a cubic metre of vault storage for your valuables. Thanks to Switzerland's high-value SFr1,000 notes, that should be enough space to salt away close to SFr1 billion in hard cash. The fee is a sight cheaper than the SFr7.5 million charge that a 0.75 per cent negative interest rate would imply.

If you don't like that idea, there is one more: **move out the risk curve to strive for returns above those offered by safe instruments in this low-return (or negative-return) world . . . but do so with caution.**

What does moving out the risk curve consist of? Essentially it means pursuing greater rewards while accepting the reduced certainty that by definition accompanies that pursuit. (If greater rewards could be obtained without a corresponding increase in uncertainty, that return increment would represent a free lunch, and most of the time they're not available.)

In a world like the one described above, perhaps the most reliable solution lies in buying things with durable cash flows. Bonds, loans, stocks, properties and companies with the likelihood of producing steady (or hopefully growing) earnings or distributions that reflect a substantial yield on cost all seem like reasonable responses in times of negative yields. **In my view, durability and dependability are highly desirable (rather than hail-Mary attempts at a moonshot). They are the Oaktree way.**

While all this might be self-evident, the challenge lies in accurately predicting the durability and growth of cash flows and making sure the price you pay allows for a good return. In today's market environment, assets with predictability are often priced extraordinarily rich, and investors are unusually willing to extrapolate growth far into the future. At the same time, with the economy and markets operating under rules that are different from those of the past in many ways – some of which are reflected above – accurate predictions are apt to prove harder to make than usual. **These are some of the reasons why, while simple in concept, investing is far from easy . . . especially today.**

October 17, 2019

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Memo to: Oaktree Clients

From: Howard Marks

Re: You Bet!

As I've written in past memos, I have an indelible recollection of the first book I read as a Wharton freshman in 1963. The book was *Decisions Under Uncertainty: Drilling Decisions by Oil and Gas Operators* by C. Jackson Grayson, Jr. (who in 1971 would take on the role of "price czar" in the Nixon administration's efforts to get inflation under control).

The best and most lasting thing I took away from Grayson's book – and the first thing I remember learning in college – was the observation that **you can't tell the quality of a decision from the outcome.** This revelation had a profound influence on me as a 17-year-old and represented the first critical building block in my understanding of how the world works.

As Grayson explained, you make the best decision you can based on what you know, but the success of your decision will be heavily influenced by (a) relevant information you may lack and (b) luck or randomness. **Because of these two factors, well-thought-out decisions may fail, and poor decisions may succeed. While it might seem counterintuitive, the best decision-maker isn't necessarily the person with the most successes, but rather the one with the best process and judgment. The two can be far from the same, and especially over a small number of trials, it can be impossible to know who's who.**

By my stage in life – if not well before – one should have figured out his strengths and weaknesses and tilted his activities toward the former. I've concluded that my strengths include the ability to:

- frame questions,
- logically organize data and weigh pros and cons,
- know what I don't know,
- accept that future outcomes aren't predictable,
- think about the future probabilistically, and
- make decisions incorporating all of the above (although far from always correctly).

Also very important has been the ability to internalize Grayson's point about decision quality (and thus live with my unsuccessful decisions from time to time). This set of attributes equipped me for a career in investing . . . **and for finding enjoyment in games of chance.**

<u>My Life as a Gambler</u>

Although I've made reference to them in some past memos, games have played a bigger part in my life than you probably know. Because of the many connections between investing and gambling, many of the investors I respect play blackjack, poker or backgammon. You might enjoy learning about my past in this regard.

Like most people my age, I spent time as a child playing card games like "War" and "Old Maid" (there were no videos to watch or video games to play, and my parents considered television a pernicious influence that had to be strictly rationed). My first brush with "grown-up" games and betting involved gin rummy starting around age 12. Hours spent playing with my three closest buddies established a pattern for life.

When I was a sophomore in college (1964-65), card games at the fraternity house took up an embarrassingly large fraction of my time. A different game occupied our afternoons each semester, including gin, pinochle, cribbage, hearts, casino, bid whist, spades and tonk (many of these have since been relegated to the dustbin of leisure-time history). Most evenings were devoted to poker. (You're right to wonder when I studied. I actually can't remember doing much of it that year.) And when I eventually got serious about my studies as an upper-classman, I took up the commensurately serious game of bridge.

The next big step came in 1970-72, when I began to ski and was introduced to backgammon back at the lodge. Although probably dismissed by non-game players as trivial, backgammon, like bridge, is a game that requires a great deal of thought and one where study and practice can lead to a very high level of skill. More on it later.

As you may know, I got Citibank to move me to Los Angeles in 1980. One of the big ways this changed my life was that it led me to meet my great friend Bruce Newberg, whose mind is perfect for handling the odds and strategies involved in games (as it is for investing). Bruce and I have had thousands of hours of enjoyment playing backgammon and gin over the last 40 years. We're probably about even financially after all that time, and if not, the winner's hourly rate of pay is in pennies. **All we get out of it is fun.** Our motto is, "The only thing worse than losing is not playing."

I also enjoy visiting a casino once in a while, and the opportunity to play blackjack. In blackjack, you and the dealer are each dealt two cards. You can "hit" or "stay" as you choose – take additional cards from the deck or decline to do so. The dealer has no choice; he's required to hit (or forced to stay) depending on his card total. In the end, whoever's total is closer to 21 without going over is the winner.

Lots of people go to casinos every year and lose money at blackjack without knowing the first thing about how to play successfully. Instead, they count on luck and hunches and say they "just play to have fun." But there are actions you can learn to take in blackjack – mostly regarding when to hit or stay – that will improve your results. These have been codified into what's called "basic strategy."

Beyond that, the key to further improving your probability of winning lies in the fact that, unlike most games of chance, in blackjack the outcomes of future hands aren't independent of the outcomes of past hands. This is so because in blackjack the dealer deals several hands in succession without returning the cards that have been played to the "shoe" from which he deals. Thus, which cards have already been dealt directly determines which cards remain to be dealt. If you can track the former through "card-counting," you can have an idea about the latter. But since the dealer's shoe can contain six or eight 52-card decks, keeping track of the cards played in itself requires exceptional skill.

Edward Thorp wrote the definitive book on this, called *Beat the Dealer*. When he won too much money, Ed was banned from the casinos and had to turn to "straight" pursuits. As a result, he studied warrants on Japanese stocks and developed the art of arbitrage. When I last saw Ed he was living an idyllic life in Newport Beach, prospering even in the absence of suits, ties or regular office hours.

But let's return to backgammon. In this game, two opponents – one moving clockwise and the other counter-clockwise – try to bring their pieces around the board while simultaneously preventing the other from doing so, and then be the first to take them off the board. Each player's ability to move forward is determined by rolling a pair of dice. It's a total disaster if you're ignorant of the probabilities governing rolls of the dice and instead rely on luck, gut instinct or what you think is your innate skill. (In fact, the most important skill in backgammon consists of knowing these probabilities and thus what actions to take given your position.)

More recently, through study Bruce has gotten too good for me at backgammon, so now we're mostly down to gin. In gin, each player is dealt 10 cards, and by alternatingly picking from the deck and discarding, you try to form them into "melds" of three or four cards of the same kind (such as 9-9-9) or in a run of the same suit (such as 4-5-6-7 of spades). As the hand goes on, you can opt to "knock" (if your un-melded cards add up to less than a certain number) or try to get "gin" (all 10 cards melded), which pays off in more points – unless your opponent knocks or gets gin first.

An aside: when I speak to students, I often say, "For me, the thing that makes investing fascinating is the fact that there's no action you can take that is sure to work, no strategy that's always a winner." To illustrate, I go on: "It's like gin. Sometimes knocking is the best thing to do, and sometimes you should play for gin." And all I get are blank stares. Few young people play cards anymore, and even fewer have ever heard of gin.

Another aside. While I don't think they're the result of conscious decisions, my life as a gambler has always exhibited two characteristics:

- First, I haven't made a serious study of the games I play. I feel if I want to work, I can go to the office.
- And second, I only play for small stakes. Some people dream of big killings, and some like the frisson attached to risking large sums. I've never felt that my enjoyment increased with the amount of money on the table. I play for fun and to test my decision-making, not to win big money. (Point of reference: back around 1990, I was visiting Ric Kayne at Lake Tahoe and he said, "Tonight I'm going to take you to the casino and make a man of you. We're going to play until you win or lose real money!" So he called the casino host and asked him to arrange a $25,000 line of credit for me. The host called back a few minutes later and said, "Sorry, Ric, I can't justify a $25,000 line for someone whose average bet is $11.")

What about coming full circle? One of the best things I ever did was to teach my son Andrew to be a game player at an early age. I now have a built-in opponent for gin and backgammon. There can be few sweeter memories than sitting on a log with him at Big Bear State Park playing War in 1992, when he was five. And it continues; my five-year-old granddaughter, Rosie, is my new opponent at War. There's nothing better!

Thinking in Bets

In a past memo, I told a story from my days as a buy-side analyst following the business equipment industry for First National City Bank. In 1970, one of the bank's portfolio managers asked me whom I considered to be the best brokerage-house analyst on Xerox. "Well," I answered, "the one who most agrees with me is so-and-so."

In other words, we tend to respect people who think like we do. Did you ever hear someone say, "I think Bob's a genius, and he thinks my views are all wrong"? That's something few people would ever say. No, we tend to think highly of people whose opinions mirror ours.

And that brings me to the source of the inspiration for this memo: a book called *Thinking in Bets: Making Smarter Decisions When You Don't Have All the Facts* by Annie Duke. (I provided a blurb for the dust jacket when it was published in 2018.) Duke completed the coursework and dissertation for a Ph.D. in psychology from the University of Pennsylvania but stopped short of receiving her degree, and for many years she was the best-known female professional poker player (with over $4 million of tournament winnings). I was rereading Duke's book while on vacation, and so many of her thoughts on poker and on decision-making in general agreed with mine that I became motivated to start on the memo you're reading now. Here are some excerpts that will show you why I was drawn to it [emphasis added]:

> Over time, those world-class poker players taught me to understand **what a bet really is: a decision about an uncertain future**. . . .
>
> Thinking in bets starts with recognizing that **there are exactly two things that determine how our lives turn out: the quality of our decisions and luck**. Learning to recognize the difference between the two is what thinking in bets is all about. . . .
>
> The result of each hand provides immediate feedback on how your decisions are faring. But it's a tricky kind of feedback because **winning and losing are only loose signals of decision quality**. You can win lucky hands and lose unlucky ones. . . .
>
> **What makes a decision great is not that it has a great outcome.** A great decision is the result of a good process, and that process must include an attempt to accurately represent our own state of knowledge. That state of knowledge, in turn, is some variation of "I'm not sure." . . .
>
> . . . we must recognize that no strategy can turn us into perfectly rational actors. In addition, we can make the best possible decisions and still not get the result we want. **Improving decision quality is about *increasing* our chances of good outcomes, not *guaranteeing* them**. . . .
>
> We are discouraged [in life] from saying "I don't know" or "I'm not sure." We regard these expressions as vague, unhelpful and even evasive. But getting comfortable with "I'm not sure" is a vital step in being a better decision-maker. **We have to make peace with *not knowing*. . . .**

> **What good poker players and good decision-makers have in common is their comfort with the world being an uncertain and unpredictable place. They understand that they can almost never know exactly how something will turn out. They embrace that uncertainty and, instead of focusing on being sure, they try to figure out how *unsure* they are, making their best guess at the chances that different outcomes will occur. . . .**
>
> An expert in any field will have an advantage over a rookie. But neither the veteran nor the rookie can be sure what the next flip will look like. **The veteran will just have a better guess**. . . .

You don't have to read far in *Thinking in Bets* before it becomes clear that Annie Duke shares Jack Grayson's interest in decision-making under uncertainty. Duke looked for real-world applications at the poker table, and Grayson in the oil patch. **But both worked on how to make decisions when faced with imperfect information and uncertain outcomes. That brings me to the subject of investing . . . and this memo.**

<u>Parsing the World of Gambling</u>

People who aren't very familiar with games or who don't dwell on them probably think they're all variations on the same theme. But actually there are big differences. I want to touch on them so I can go on to create an effective analogy between gaming/gambling and investing. Importantly, games vary in three primary dimensions: information availability, luck and skill.

Some games (but not all) require players to deal with uncertainty. Whether you or your opponent will win – or what action you should take – might hinge on information that's not available to you, and about which you can make inferences or guesses at best. **Thus in some games, there's important "hidden information,"** and in others there isn't. In poker, blackjack and gin you don't know what cards your opponent is holding. But in chess and backgammon, everything's plain to see: the position of the playing pieces on the board. Nothing is hidden. Obviously this is a big difference. Where no information is hidden, the game is reduced to the other two elements.

After the conditions have been set (the cards have been dealt or the pieces are in their positions on the board), there's another source of uncertainty. **In some games subsequent developments will be influenced by luck**, and in some they won't. Take the two games I said don't involve hidden information: chess and backgammon. In chess, there's no such thing as luck – no dice to throw or cards to draw; the key variable is the moves your opponent chooses to make. (I guess there is one element of luck: how skillful is the opponent you've drawn?)

In backgammon, on the other hand, the moves a player gets to make are entirely determined by what numbers come up when he rolls the dice. And in card games, what cards he and his opponent draw is subject to luck. Sometimes these things are total unknowns – a matter of sheer randomness – and in others, while the outcome can't be predicted with certainty, probabilities can be assigned.

- In blackjack, for example, we can know something about the cards that will come out in the future if we can keep track of the ones that already have been played.

- And in backgammon, we know with absolute certainty the probability of every possible result of rolling the dice: over a large number of rolls, the number seven will come up 16.7% of the time (six of the 36 possible outcomes on a roll of the dice), and the number twelve will come up only 2.8% of the time (one out of the 36). Of course, even if we know the probabilities, we still don't know which number will come up on any one roll.

Finally, in some games skill is important, and in others it isn't. There's skill (albeit with varying degrees of difficulty) in all the games I've discussed so far: chess, backgammon, poker and gin. Games with and without hidden information can entail skill, and games affected and unaffected by luck can entail skill.

But the role of skill isn't universal in games/gambling. Roulette and wheel-of-fortune are games of pure chance or luck. The outcome is entirely a matter of random events that can't be predicted at all, like which slot in a roulette wheel the ball will fall into when the wheel stops spinning. And since there's no ability to predict future developments, there's no such thing as skill: only luck.

- In the early 1980s, I used to go to Las Vegas with a now-departed friend. He spent a lot of time (and money) on wheel-of-fortune, which is nothing but vertical roulette. I used to tell him he was "the world's greatest wheel-of-fortune player." Since he thought there actually was such a thing as playing the game well, he never got the joke.
- There's a very interesting example in *punto banco*, a form of baccarat. As Wikipedia says, "In *punto banco*, each player's moves are forced by the cards the player is dealt." That is, there are no decisions to make, so clearly no such thing as skill in decision-making. You sit down, place your bet, receive your cards, and either win or lose. One version of history says baccarat was invented for the enjoyment of a king who wasn't smart enough to learn to play games; thus one was developed that required no decisions . . . and thus entailed no skill.

Note from the above the different types of games:

- No hidden information, no luck, skill. (Chess)
- No hidden information, luck, skill. (Backgammon)
- No hidden information, luck, no skill. (Roulette)
- Hidden information, luck, skill. (Blackjack, poker)

Now we can drill down. Here are some important observations:

- Where there's no skill involved, the outcome has to depend entirely on luck.
- But even if skill is involved, luck can still play a role.
- The presence of luck doesn't necessarily preclude a role for skill. **In fact, making intelligent decisions when future events are uncertain is one of the greatest forms of skill.** It's what Grayson's and Duke's books are all about.
- **Likewise, the ability to deal intelligently with hidden information has to be based on skill.**

Creating this taxonomy, or "scheme of classification," not only allows me a chance to educate non-game-players, but it also provides a framework for a comparison to investing (if you hadn't noticed).

How Is Investing Like Gambling?

Hidden information, luck and skill can play a part in investing. In active investing involving public companies, for example, all three are involved.

- Clearly, no one knows all the relevant facts. The SEC tries to make sure all investors have **equal access** to information, but not necessarily **complete access**. For example, investors won't know about first-quarter developments at a company until it reports earnings in May. And no one is supposed to know the results of drug trials and beta tests until they're made public.
- Luck – random, unpredictable, often-exogenous events – affects companies and their stocks all the time. Many aspects of corporate performance and profitability can be influenced by weather, for example. And the TV network carrying the World Series is likely to enjoy much greater ad revenue if the teams playing come from major markets rather than small ones.
- Finally, the superior investor has the skill required to better assess revenue and profit potential, where we stand in the cycle, the fairness of an asset's price and the margin of safety it affords. No one gets these things right all the time, but the superior investor does so more often than most.

Not all investing, however, entails all – or necessarily any – of the three elements. Take, for example, index investing. The index fund manager's job is to produce the same return as the relevant index.

- There's no such thing as hidden information. The only information the investor needs to succeed at his job relates to the composition of the index in question, and there's no mystery in that regard.
- Likewise, there's no luck. The forces that influence the securities in the index will have exactly the same influence on a properly constructed index fund.
- And finally, there's no skill. All it takes is a well-programmed computer to keep the fund's portfolio in line with the index, and that isn't hard to find.

It's worth delving into the matter of investing skill. The efficient market hypothesis posits that (a) markets are "efficient," (b) thus assets are priced fairly and there are no bargains or overpriced assets, and (c) as a result, there's no scope for skill or "alpha," defined as the ability to outperform by capitalizing on mispricings. The traditional view of active investing, which ignores this hypothesis, is that investing is like blackjack, meaning it's possible for some people to be better at it than others. But if the efficient market hypothesis is right, investing is like roulette, with investors' returns beyond their control and solely a function of luck, or what the market does. (Of course, a portfolio's return can be amplified or diminished relative to the market's return by the portfolio's relative sensitivity to it: the "beta." And that leads to the question of whether investors have the skill to move beta up and down in a timely fashion.)

In most markets, the concept of efficiency is neither an absolute truth nor completely inapplicable. **Some markets may be less efficient than others; thus skill may be more relevant in some markets than in others.** Where skill is highly relevant, markets are called "alpha" markets. Where it's not – and the portfolio return is mostly a function of the market's return and the portfolio's sensitivity to market movements – they're called "beta" markets. Obviously it's important to figure out which type of market you're working in.

For years, people (whether consciously or not) treated the stock market as an "alpha" market, and equity portfolio managers were able to charge substantial management fees for their efforts. But over time, it was increasingly observed that most active investors were incapable of consistently outperforming the market indices (especially after fees). That meant skill was lacking: you could get the same result or better by passively emulating an index. Investors concluded that they would no longer pay for alpha in a beta market, and that's the main reason for the growth of passive investing. **Why pay someone to play for you in a game where there's no such thing as skill?**

What's the bottom line? **In my view, the active investing I'm interested in – hopefully in markets that are less efficient – involves all three of the ingredients under discussion: hidden information, luck and skill. Thus it's most like poker and blackjack, not chess.** It's in that vein that I'll proceed.

The Essence

One of the most important aspects of skill in gambling consists of figuring out which possible outcome to bet on, and when to bet heavily and when not to. This is where all facets of the decision come together.

Gauging the likely outcome – How likely is one participant (you?) to win, and how likely is someone else? Whether in card games, backgammon or sports betting, there are a number of factors to consider. The most important are these:

- How good is your current position?
- How many paths do you have to winning (and to losing)?
- To what extent would it require good luck regarding throws of the dice or draws of the cards for you to win? And what's the probability your opponent will enjoy good-enough outcomes for him to be the winner instead?

The job here is to "handicap" the outcome, defined by Merriam-Webster as "to assess the relative winning chances of (contestants) or the likely winner of (a contest)." Which poker player has the best hand? Who's in the better position on the backgammon board? Or for the bettor, which horse is likely to win the race, or which team is likely to win the game? **To put it simply, who's the favorite?**

Many people think figuring out who's most likely to win is all you have to do to successfully bet on card games, backgammon or sports. They're missing a huge part of the matter, and perhaps the far more important part.

Assessing the proposition – There's usually not much mystery involved in identifying the favorite. It's pretty clear who's ahead in backgammon. It's more of a challenge in card games, where players hold cards the others don't know about, but still it's possible to have a sense for how good one's hand is in absolute terms. And in most cases there's a solid consensus around which horse or team is most likely to win.

But one of the most important things to know about gambling is that information that's available to everyone isn't likely to produce winnings. Since most people know who the likely winner is in a hand of cards, a backgammon game that's underway or a sports bet, that isn't valuable information. **Everyone might like to bet on a favorite, but that means it's unlikely they'll be able to find someone to take the other side of the wager: to bet against the favorite without an inducement.**

That inducement takes the form of a "proposition." Consider a football matchup in which Team A is considered twice as likely to win as Team B. Stated another way, Team A is viewed as likely to win two times out of three, and Team B only once. If it's common knowledge that Team A is that much better, no one will bet on Team B unless the person who favors Team A is willing to "lay odds." That is, Joe might tell Ed, "I'll give you 2-to-1 odds; I'll bet $10 against your $5 that Team A will beat Team B." Assuming the outcomes go according to expectations, Joe wins $5 two times out of three and loses $10 one time. Over three games, then, the two bettors come out even. That means 2-to-1 odds are "fair" in this situation.

So here's the bottom line: the goal isn't to figure out who the favorite is and bet on it. Rather, the goal is to figure out who the favorite is **and whether the odds are fair or not**.

- If the odds are fair, as illustrated above, there's no reason (other than sentiment) to bet on one team or the other.
- If the odds don't penalize the favorite enough – let's say the odds on the above matchup are only 6-to-5 – you should bet on the favorite. Team A will win two-thirds of the time. The one time out of three when they lose, the $6 you pay won't offset the total of $10 you win on the two occasions when they come out ahead.
- But if the odds are tilted against the favorite – the odds are "too long," maybe 4-to-1 – it's better to bet on the underdog. You'll still lose $1 two times out of three (for a total of $2), but on the one game you win, the $4 payoff will more than compensate.

A great example can be seen in the world of backgammon. The player who's ahead can offer to double the stakes from $5 to $10 by "turning the cube," in which case the other player has to choose between surrendering for $5 or playing on for $10. Since the leader offers to double because he's ahead, does that mean it's a mistake for the player who's behind to accept? Not necessarily.

- Clearly, if the laggard surrenders, he loses $5.
- But what if, let's say, he has a 25% chance of winning and plays on for $10? In that case, his expected outcome is ($10 loss x .75) + ($10 gain x .25), which works out to the same $5 loss.

The lesson from the above is that a player who is behind should accept a double whenever his chance of winning exceeds 25%, which would give him an expected loss that's less bad than surrendering for $5. **Sometimes it's a good idea to bet on an inferior position . . . even though doing so is expected to result in a loss most of the time. It all depends on the proposition.**

My friends Matt Bensen and Corey Robinson provided an apt excerpt from a speech titled "The Art of Stock Picking" by Charlie Munger. In it, Charlie compares investing with the pari-mutuel betting system at the racetrack, where the payoff for each horse winning is determined by how many people bet on it:

> If you stop to think about it, a pari-mutuel system is a market. Everybody goes there and bets and the odds change based on what's bet. . . . Any damn fool can see the horse carrying a light weight with a wonderful win rate and a good post position etc., etc. is way more likely to win than a horse with a terrible record and extra weight and so on and so on. But if you look at the odds, the bad horse pays 100 to 1, whereas the good horse pays 3 to 2. Then it's not clear which is statistically the best bet . . .

Success in gambling doesn't go to those who pick winners, but to those with the ability to identify superior propositions. The goal is to find situations where the odds are generous to one side or the other, whether favorite or underdog. In other words, a mispricing.

It's exactly the same in investing. People often say to me, "XYZ is a great company with a bright future, so I bought the stock." They're picking a favorite but ignoring the proposition. The former alone isn't enough; they should consider the latter as well.

Likewise, one might say that even the best venture capitalists are poor at picking winners, since a lot of their investments result in losses. But the payoff on the ones that succeed is so large, it's sufficient to pay for the losers many times over and make the overall effort a great success.

While in investing we generally aren't offered explicit odds, the attractiveness of the proposition is established by the price of the asset, the ratio of the potential payoff to the amount risked, and what we perceive to be the chance of winning versus losing.

Superior investors may be superior because they can figure out which companies are likely to be winners. **But the best investors I know also have a sense – perhaps innate and instinctive – for situations where the proposition is too favorable relative to the underlying fundamentals.** It might be a company whose securities are cheap enough to more than compensate for its poor prospects, or one where the future is exceptionally bright, but its securities aren't priced high enough to charge fully for that potential.

In May 1968, when I showed up at First National City Bank for a summer job in the investment research department, the bank (and many other banks) invested primarily in the "Nifty Fifty." These were considered to be the best and fastest-growing companies in America: companies so good that there was "no price too high." And if you bought those stocks the day I arrived and held them firmly for five years, **you lost almost all of your money . . . investing in the best companies in America.** All the companies were considered future winners. Some actually were, but far from all. (What happened to Kodak, Polaroid and my favorite, Simplicity Pattern?) The proposition was wrong: they were priced as if they couldn't lose, and it turned out several would.

Then, in 1978, I switched to Citi's bond department, and I was asked to start a high yield bond fund. Now I was investing in **the bonds of the worst public companies in America** – all rated speculative grade, or "junk." And I was making good money safely and steadily. Not because the companies were flawless – in fact, about 4% by dollar amount would go on to default each year on average – but because "the price" was too favorable to those who bet on them.

This experience produced two of my most important observations:

- **Success in investing doesn't come from buying good things, but from buying things well, and it's essential to know the difference.**
- **It's not a matter of what you buy, but what you pay for it.**

Nifty Fifty investors spent all of their time picking favorites and failed to notice that the prices they paid were too high. **Mostly winning companies, but poor investments.**

And because popular opinion was stacked so heavily against high yield bonds, those who invested in them received excessive compensation for taking the associated risk: **the proposition was too good**. Moody's defined a B-rated bond as one that "fails to possess the characteristics of a desirable investment." In other words, Moody's panned those bonds because they were underdogs but never asked about the price. It's usually non-objective, too-positive or too-negative attitudes like these that give rise to propositions that are too good or too bad for the takers. That's what we should search for as investors.

<u>Guest Contributor</u>

As I mentioned on page three, one of the best things I ever did was to encourage my son Andrew to develop a love of games. In Andrew's case, he applied the same seriousness to games that he does to investing and his other pursuits. This gave him the thought process of a gambler and enables him to suggest the following ways in which gambling has parallels to investing:

- **Game selection versus skill** – When considering where to invest, it's important to understand both how much of the requisite skill you possess and the quality of the competition. Being a consistent winner among the best gamblers or in the most intensely competitive markets can be very difficult. Instead, your energy might be better spent looking for less-efficient niches. Unfortunately, it's harder to find them than it was decades ago.
- **Increasing efficiency/the tendency of markets to adapt** – In the early days of online poker, it was easy for decent players to win, and a lot of amateurs were enticed to play by seeing a newcomer win the World Series of Poker. After some time, however, the games became tougher as they attracted professional players, and the amateurs lost their money. The new, more sophisticated generation of competitors learned their predecessors' tendencies, improved on their strategies and started beating them. In this way, changes in the arena and in participants' behavior can cause what worked years ago to not work today.
- **Circle of competence** – Just because you're great at gin rummy doesn't mean you should play Texas Hold'em against a professional poker player. It's important to know your strengths and stick to them.
- **Not having to play every hand** – There's no requirement to bet on every game or every hand. You can wait until you get a particularly attractive proposition, one that you feel particularly capable of analyzing and understanding, and where the odds are on your side. In the interim, it's better to sit out and protect your bankroll.

- **The importance of not just winning and losing, but of maximizing wins and minimizing losses** – The key is to bet big when you have a big edge and small when you have less of an edge . . . and to know the difference. As Charlie Munger puts it, "The wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time, they don't. It's just that simple." Everyone will have both winners and losers. Various factors will determine the ratio. But the ability to assess propositions can enable you to win more on your winners than you lose on your losers. The size of your bet should take into account both the probability you are correct about who's going to win and the asymmetry of the potential payout. "Getting your money in" when you have a great hand is one of the most important keys to winning at poker. You don't get many great hands, so when you do, you have to be sure to take maximum advantage.
- **Being able to make it through downturns** – It's important to have discipline when risking your capital, so that you can survive unfavorable periods and still be around when the winners show up. You have to avoid the risk of ruin, and this requires solid discipline (you must "never forget the six-foot-tall man who drowned crossing the river that was five feet deep on average"). To that end, good play isn't just a function of relying on the expected value of your holdings and pure math, but also of thinking broadly about risk. Would you bet all your money on an 80/20 favorite?
- **Adjusting your play based on the environment** – In poker, if your competition is weak, you may decide to play more hands regardless of their strength and bet more aggressively, while against strong players you may tighten up and only play premium hands.
- **Overcoming emotion and biases** – Human failings can cause gamblers to "chase" in poker (overstay in a hand in the hope of getting a lucky card), play loose (bet too much) when they're "steaming" (smarting from losses and thus driven by heated emotion), and take bad doubles in backgammon. Hope, emotion and optimism are the gambler's enemies.
- **Second-level thinking** – It's not just how good your hand is. There's much more. How good does your opponent think your hand is? How good do you think your opponent's hand is? How good does he think you think his is? How is that motivating his actions? The consistent winner has to be able to think at a higher, more complex level than the rest.

All the ideas discussed above are important in investing, just as they are in gambling. In both pursuits, it all comes down to Jack Grayson's title: *Decisions Under Uncertainty*. As I've learned in the 56 years since first reading his book:

- You have to be able to understand which companies or assets are favored <u>and</u> the attractiveness of the proposition.
- You need a sense for whether your holding is a good one <u>and</u> for the chance the competition – the market, which you're playing against – might have better.
- You need the discipline to follow a process <u>and</u> the wisdom to accept that no process is sure to produce good results.
- You have to understand the significance of the information you have, as well as that which you don't have. You need the nerve to bet heavily based on what you think you know <u>and</u> a healthy respect for what you may not know.
- You need to control greed and fear, hopefulness and despondency. You have to resist making an unwise bet just because it could enable you to catch up with the indices or the competition.

Since her book provided the impetus for this memo, I'll let Annie Duke sum up. She'll be talking about poker, but it'll sound a lot like investing [emphasis added]:

> When we think probabilistically, we are less likely to use adverse results alone as proof that we made a decision error, because we recognize the possibility that the decision might have been good but luck and/or incomplete information (and a sample size of one) intervened.
>
> Maybe we made the best decisions from a set of unappealing choices, none of which were likely to turn out well.
>
> Maybe we committed our resources on a long shot because the payout more than compensated for the risk, but the long shot didn't come in this time.
>
> Maybe we made the best choice based on the available information, but decisive information was hidden and we could not have known about it.
>
> Maybe we chose a path with very high likelihood of success and got unlucky. . . .
>
> But it also means we must redefine "right." **If we aren't wrong just because things didn't work out, then we aren't right just because things turned out well**. . . .
>
> First the world is a pretty random place. The influence of luck makes it impossible to predict exactly how things will turn out, and all the hidden information makes it even worse. If we don't change our mindset, we're going to have to deal with being wrong a lot. . . .
>
> Poker teaches that lesson. A great poker player who has a good sized advantage over the other players at the table, making significantly better strategic decisions, will still be losing over 40% of the time at the end of eight hours of play. **That's a whole lot of wrong. And it's not just confined to poker**. . . .
>
> How can we be sure that we are choosing the alternative that is best for us? What if another alternative would bring us more happiness, satisfaction, or money? The answer, of course, is we can't be sure. Things outside our control (luck) can influence the result. **The futures we imagine are merely *possible*. They haven't happened yet.** We can only make our best guess, given what we know and don't know, at what the future will look like. . . . When we decide, we are betting whatever we value . . . on one of a set of possible and uncertain futures. **That is where the risk is.**

Investing is a game of skill – meaning inferior players can't expect to be above average winners in the long run. But it also includes elements of chance – meaning skill won't win out every time. In the long run, superior skill will overcome the impact of bad luck. But in the short run, luck can overwhelm skill, and the two can be indistinguishable.

These are the things that make investing both challenging and stimulating. They're the reason I feel good about the way I chose to spend my career.

January 13, 2020

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Memo to: Oaktree Clients

From: Howard Marks

Re: Nobody Knows II

I wrote most of this memo over this past weekend, on the heels of the tumultuous seven-day correction. But I couldn't get it out on Monday, and that day the S&P 500 rallied by 4.5%, or 135 points, for the biggest point gain in its history. I just can't update it daily to take into account every rise or fall (or rate cut). And my real goal – as usual – is to suggest how to think about developments, not to say "buy" or "sell." **So please read this memo as of Sunday afternoon – whatever the markets have done since – and let me show how I assess the recent events.**

* * *

I last used this memo title on September 19, 2008, two days after Lehman Brothers' bankruptcy filing. This is certainly an appropriate time to recycle it.

Over the last few weeks, I've been asked repeatedly for my view of the coronavirus and its implications for the markets. I've had a ready answer, thanks to something from my January memo, *You Bet!* As you may remember, I drew heavily on quotations from Annie Duke's book on decision making, *Thinking in Bets*. The one that stayed with me most – and that I've used a lot since the memo was published on January 13 – is this one:

> An expert in any field will have an advantage over a rookie. But neither the veteran nor the rookie can be sure what the next flip will look like. **The veteran will just have a better guess**. (Emphasis added)

In other words, if I said anything about the coronavirus, it would be nothing but a guess.

I've written in the past about my reaction when people in China ask for my view of their country's future. "You live there," I say. "I don't. Why are you asking me?" Not only am I not an expert on China, but I firmly believe the future of a country isn't subject to prediction, especially one that operates under a system that's unique. I furnish my opinion of China's future, but I hasten to point out that it's nothing but a hunch. **People may ask me for my opinion because they think I'm intelligent, think I've been a successful investor, or know I've lived through a lot of history. But none of that should be confused with expertise on subjects of every kind.**

And that leads me back to the coronavirus. No one knows much about it, since this is its first appearance. As Harvard epidemiologist Marc Lipsitch said on a podcast on the subject, there are (a) facts, (b) informed extrapolations from analogies to other viruses and (c) opinion or speculation. **The scientists are trying to make informed inferences. Thus far, I don't think there's enough data regarding the coronavirus to enable them to turn those inferences into facts. And anything a non-scientist says is highly likely to be a guess.**

So, overall, there are facts, inferences and guesses. It's always essential to know which you're dealing with. As for the virus, I don't think anybody knows the answers to the following questions:

- **How does the virus travel from person to person and community to community?** – People have tested positive who had no known contact with other people who had it or who were in countries in which there are known outbreaks.
- **How many people will contract it?** – On February 28, the head of the World Health Organization said it had "increased our assessment of the risk of spread and the risk of impact of COVID-19 to very high at a global level." According to Dr. Lipsitch, it will affect 40% to 70% of all adult Americans. (I only provide this as an example. I don't assert that it's correct, or that his is the opinion to accept.)
- **Will it recede?** – According to the reported data, the number of new cases in China has declined substantially, from 9 out of 13 days with more than 3,000 the first half of February, to 8 out of 9 with less than 500 at the end of the month. How much of this is a function of the restriction of people's freedom of movement? To what extent can this downtrend be extrapolated to the rest of the world? Some say the virus will recede when the weather turns warm, as happens with other flus. Will that apply in this case?
- **What will its effect be?** – To date, only 20% of those contracting the virus have experienced something described as more than "mild," and the fatality rate has been only 2-3% of those infected. Will these percentages hold? Will the fatalities continue to be primarily among people who are elderly and/or compromised? 2% of Dr. Lipsitch's 40-70% suggests **a million deaths** in the U.S. On the other hand, according to Dean Jamison, a global health economist and professor emeritus at University of California, San Francisco:

  > . . . the U.S. has a superior health system to China, where the outbreak is centered, and months of warning. . . . "I think we're unlikely to see a really large outbreak in the U.S. — meaning **thousands of deaths**," he said. (*The Wall Street Journal*, March 2)

- **What countermeasures will be taken?** – Will schools and offices be closed? Will people be told to stay in their homes? Will food be delivered to homes as in China? Will large public events be canceled? Will a vaccine be invented, and when?
- **What will be the effect on the economy?** – If people are shut in at home and unable to go to work, shop, eat out or travel as usual, how will GDP be impacted? How will a negative wealth effect impact people's propensity to spend? "Zero GDP growth" means the same thing as "same as last year" – is that an optimistic expectation or a realistic one?
- **How will the markets react?** – Since the markets' reaction ultimately will be a function of both economics <u>and</u> emotion, it seems impossible to quantify how far it'll go.

I want to stress that the purpose of the above discussion isn't to give answers or to appear to be complete or authoritative. If anything, it's to indicate the degree of uncertainty. If it's true, as I think, that these things are currently unknown and unknowable, then clearly there can be no such thing as a reliable statement regarding the implications of the virus.

The Economic Impact

In the early days of the disease, when the coronavirus was something that was happening "over there," the effects likewise were mostly second-hand:

- obviously, a major contraction of the Chinese economy due to factory closures,
- the decline in retail spending in Asia,
- the curtailment of travel to and from Asia, and
- the important impact of shutting down an essential part of the world supply chain.

The supply-chain effects are particularly important. The unavailability of a small Chinese component can cripple the production of a large piece of equipment. And it only takes one, unless there are alternative sources. Relocating sourcing will be a challenge: it'll take time, and there's no assurance that the new locations won't become engulfed in the disease.

More recently, the repercussions have moved beyond Asia and closer to the U.S., and they have grown in scale for the non-Asia world:

> Nestlé SA told more than 290,000 employees to suspend international business travel until March 15. Several U.S. airlines are canceling flights to China and waiving change fees for passengers traveling to other affected destinations. U.S. apparel and footwear companies are facing supply-chain delays, which could result in a shortage of spring goods. Toy aisles may be bare as production of Barbies and Nerf guns in China flattened. And containership operators have canceled 40 sailings at the Port of Los Angeles through April 1, mostly for vessels coming from China. (*The Wall Street Journal*, March 2)

The reasons for the economic impact are understandable, but their collective impact can't be quantified any more than most economic phenomena, and probably less given how much the elements in this situation are in flux. **There are as many forecasts as there are forecasters:**

> S&P Global is forecasting the U.S. economy to slow to a 1% annual growth rate in the first quarter from 2.1% pace in the fourth quarter of 2019, with a half-percentage point attributable to the coronavirus. For the full year, the effect would be modest, shaving one or two tenths of a percentage point off growth. But that forecast assumes the impact is mainly overseas. (*The Wall Street Journal*, March 2)
>
> Mr. Jamison [the UCSF emeritus professor introduced above] said such a scenario could still cause U.S. businesses and schools to close, grind transportation networks to a halt, and trim a half percentage point from economic growth for the year. That is enough to slow the economy but not cause a recession, or two straight quarters of economic contraction. He expects any event wouldn't last longer than several months and be followed by a sharp increase in economic activity. (Ibid.)
>
> "You have all the ingredients for an interruption of economic activity here," said Carl Tannenbaum, chief economist for Northern Trust. "The impact of what's going on is being underappreciated," he added. "I don't think the presumption of a month ago, that this will blow over, is an appropriate posture at this point." (Ibid.)

> Self-Fulfilling Expectations Pose Real Economic Risks: Consumers increasingly expect the economy to get worse. Morning Consult's Index of Consumer Expectations (ICE) fell 2.5 points since Feb. 24 and currently stands at 112.9. The fear for policymakers is that the slide in consumers' future expectations becomes a self-fulfilling prophecy: As more consumers expect the economy to contract in the coming months, they become more likely to delay discretionary purchases, which in turn drives down aggregate U.S. demand. (Morning Consult, March 1)

Investor Reaction

The markets' decline in the seven trading days February 20-28 certainly represents a very strong negative reaction. The S&P 500, for example, declined by 432 points, or 12.8%. Here are a couple of indications of its magnitude:

> The market crash in the past two weeks has been truly historic: its probability of occurrence is ~0.1% since 1896; the velocity of the plunge and of the VIX surge is the fastest on record; and the 10-year [Treasury yield] is at all-time low. (Hao Hong, BOCOM International, a subsidiary of Bank of Communications, March 1)

> While we are merely days into it, this stress episode is already among the most substantial of the last 25 years, joining an elite group that includes Asian Contagion (1997), LTCM (1998), the WTC attack (2001), the Accounting Scandals (2002), the Big One (2008-2009), the Flash Crash (2010), the Eurozone Crisis (2011), the China "re-peg" (2015) and the VIX event (2018). (Dean Curnutt, Macro Risk Advisors, March 1)

There's no doubt about the fact that the coronavirus represents a major problem, or that the reaction so far has been severe. **What really matters is whether the price change is proportional to the worsening of fundamentals.**

For most people, the easy thing is to say that (a) the disease is dangerous, (b) it will have a negative impact on business, (c) it has kicked off a major reaction to date, and (d) we have no way of knowing how far the decline will go, so (e) we should sell to avoid further carnage. But none of the above means selling is necessarily the right thing to do.

All these statements reflect a measure of pessimism. However, there's no way to tell whether that pessimism is appropriate, inadequate or excessive. I wrote in *On the Couch*, (January 2016) that "**in the real world, things generally fluctuate between 'pretty good' and 'not so hot.' But in the world of investing, perception often swings from 'flawless' to 'hopeless.'** " What I can say is that a month ago, most people thought the macro outlook was uniformly favorable, and they had trouble thinking of a possible negative catalyst with a serious likelihood of materializing. And now the unimaginable catalyst is here and terrifying.

(There are a few important lessons here. First, the catalyst for a recession or correction isn't always foreseeable. Second, it can seemingly appear out of thin air, as this virus seems to have done. And third, the negative effect of an unforeseeable catalyst is likely greater when it collides with a market that reflects so much optimism that it is "priced for perfection.")

Before leaving this subject, I want to make mention of some illogicalities that mark the current market reaction, telling me that the market can't be relied on to reflect reason:

- Some people are comparing the coronavirus and its market reaction to the events of 9/11. But that was a one-day event, and there's no reason to consider that an appropriate model for this instance.
- It can be argued that the carnage to date has been indiscriminate. The shares of Amazon and Alphabet (Google) experienced declines in line with that of the overall market. But certainly since they don't rely on visits from customers, they might be expected to be more immune to the effect of the virus than most. And Amazon – featuring e-tail orders and at-home deliveries – could actually find advantages in the current situation.
- Not only were stocks hit over the last week, but so was gold. Since gold is supposed to be the ultimate source of protection in times of dislocation, I can't imagine any reason why it should decline in sympathy with stocks in a market correction.
- In a flight to safety, people have flocked to the 10-year Treasury note, bidding up its price and dropping its yield to 1.1%. If you think about it, this isn't very different from the negative interest rates I complained about in October. How can it be anything but a manifestation of extreme fear to make an investment that guarantees a return of 1.1% a year for the next ten years? And consider that question in the light of the 2% dividend yield on the S&P 500, or perhaps its earnings yield of almost 6% (based on prior earnings forecasts). I'm not a dyed-in-the-wool devotee of equities, but how can buying the 10-year at these yields make better sense.

Finally I want to call your attention to the "elite group of stress episodes" of the last 25 years enumerated just above by Dean Curnutt. Every one of them was gut-wrenching. And they were followed by recoveries that produced significant gains for stalwart investors.

Most investors seem to think in terms of a very simple relationship: bad news → price declines. And certainly we've seen some of that over the last week or so. But I've argued in the past that there's more to the story. The real process is: bad news + decline in psychology → price declines. We've had bad news, and we've had price declines. **But if psychology has declined too much, it might be argued that the price declines have been excessive given the news, as bad as it is.**

Monetary and Fiscal Policy

The good news is that many market participants are counting on the world's central banks and treasuries to help pull us out of any economic slowdown. Here's one example:

> [On February 28,] Fed Chairman Powell released a short statement saying, "The fundamentals of the U.S. economy remain strong. However, the coronavirus poses evolving risks to economic activity. The Federal Reserve is closely monitoring developments and their implications for the economic outlook. We will use our tools and act as appropriate to support the economy." Following Powell's statement,

> futures markets moved to fully price in a 50-basis-point rate cut on March 18. (RDQ Economics, February 28)

Market participants seem to think that (a) rate cuts and other stimulus are always a good thing and (b) they'll work. Yet, given that the economic impact of the disease is unknowable, how can investors be sanguine about the ability of the Fed (plus other central banks and treasuries) to counteract it?

Fifty basis points this month may or may not be enough to stem the tide. But investors probably infer from Powell's "we will use our tools and act as appropriate" language that the Fed will "do what it takes." But we must be mindful of the limitations on "ammunition" that exist. In *On the Other Hand* (August 2019), I supplied a list of "ways in which low rates are undesirable and potentially harmful." The last one was this:

> Finally, but very importantly, when interest rates are low, central banks don't have at their disposal as much of their best tool for stimulating economies: the ability to cut rates.

The normal program of rate cuts covers roughly 500 basis points. That's not a very encouraging thought when we think about the fact that the short rate already stands at a mere 150 bps. So the one thing we know is that the Fed doesn't have room for a normal regime of rate-cutting (there's uniform insistence that it won't cut into negative territory).

Further, we have to wonder about the desirability of using 50 bps of the 150 bps the Fed does have at its disposal. Will it be enough? **And what will the Fed be able to do when the economic impact of the virus has been muted but we only have 100 bps or less left with which to fight any recession that appears?**

The facts regarding monetary and fiscal policy are these:

- In 2009, to fight the Global Financial Crisis, the Fed cut short-term rates to zero for the first time.
- Not wanting to derail the subsequent recovery, it hesitated to raise rates before Chair Yellen enacted a series of rate increases in 2015-18 that took the Fed funds rate to 2.25-2.50%.
- When around the end of 2018 interest rates reached levels that investors feared would jeopardize the economic expansion, Chair Powell's Fed reversed course and embarked on a series of three rate cuts.
- Thus today we have the 150 bps I mentioned above – "limited ammunition."
- In addition to rate cuts, the Fed has the ability to pump liquidity into the economy by engaging in quantitative easing through purchases of government securities. But we can't know the long-term impact of expansion of the Fed's balance sheet.
- Finally, looking away from the Fed, we can think about fiscal policy (i.e., increased deficit spending). But this will add even more to our national debt.

Normally, fiscal and monetary stimulus is applied in times of economic weakness. (Even Lord Keynes, whom many people consider the father of deficit spending, advocated running deficits and accumulating debt when the economy grows too slow to create jobs, and then repaying the debt when the stimulus produces surpluses.) Now we have near-zero interest rates and trillion-dollar deficits in times of prosperity. No one wants a recession, but using up our ammunition preemptively may not have been smart.

The Fed/government's tool for fighting the economic impact of coronavirus are very limited. Thus I believe it's undesirable to be highly sanguine about their powers at this juncture.

What to Do?

These days, people have been asking me whether this is *the time* to buy. My answer is more nuanced: it's probably *a time* to buy. There can be no unique time to buy that we can identify. The only thing we can be sure of today is that stock prices, for example, are a lot lower in the absolute than they were two weeks ago.

Will stocks decline in the coming days, weeks and months? This is the wrong question to ask . . . primarily because it is entirely unanswerable. Since we don't have answers to the questions about the virus listed on page two, there's no way to decide intelligently what the markets will do. We know the market declined by 13% in seven trading days. There can be absolutely no basis on which to conclude that they'll lose another 13% in the weeks ahead – or that they'll rise by a like amount – since the answer will be determined largely by changes in investor psychology. (I say "largely" because it will also be influenced by developments regarding the virus . . . but likewise we have no basis on which to judge how actual developments will compare against the expectations investors already have factored into asset prices.)

Instead, intelligent investing has to be based – as always – on the relationship between price and value. In other words, not "will the collapse go further?" But rather "has the collapse to date caused securities to be priced right; or are they overpriced given the fundamentals; or have they become cheap?" I have no doubt that assessing price relative to value remains the most reliable way to invest for the long term. (It is the thrust of the whole discussion just above that there's nothing that provides reliable help in the short term.)

I want to acknowledge up front that ascertaining intrinsic value is never a simple, cut-and-dried thing. Now – given the possibility that the virus will cause the world of the future to be very different from the world we knew – is value too unascertainable to be relied upon? In short, I don't think so. What I think we do know is that the coronavirus is not a rerun of the Spanish flu pandemic of 1918, "which infected an estimated 500 million people worldwide – about one-third of the planet's population – and killed an estimated 20 million to 50 million victims, including some 675,000 Americans." (history.com) Rather, it's one more seasonal disease like the flu, something we've had for years, have developed vaccines for, and have learned to deal with. The flu kills about 30,000-60,000 Americans each year, and that's terrible, but it's very different from an unmanageable scourge.

So, especially after we've learned more about the coronavirus and developed a vaccine, **it seems to me that it is unlikely to fundamentally and permanently change life as we know it, make the world of the future unrecognizable, and decimate business or make valuing it impossible.** (Yes, this is a guess: we have to make some of them.)

The U.S. stock market's down about 13% from the top. That's a big decline. It would be a lot to accept that the U.S. business world – and the cash flows it will produce in the future – are worth 13% less today than they were on February 19. That sentence may make it sound like I think the market's undervalued. But that's not the proper interpretation. If it was overvalued on the 19th, rather than being undervalued today, after the decline, it could just be less overvalued. Or it could be fairly valued, or even undervalued, but it isn't necessarily.

I think the stock market was overvalued two weeks ago . . . somewhat. That means I think that today, even with the short-term prospects of business somewhat diminished, it's closer to fairly valued, but not necessarily a giveaway. In the starkest numerical terms, before the rout, the p/e ratio on the S&P 500 was 19 or so, roughly 20% above the post-World War II average (and there are arguments on both sides regarding the current applicability of that average). Thus, after a 13% decline, you'd have to say the p/e ratio is pretty close to fair (unless earnings for the year will be very different from what they previously had been expected to be).

Buy, sell or hold? I think it's okay to do some buying, because things are cheaper. But there's no logical argument for spending all your cash, given that we have no idea how negative future events will be. What I would do is figure out how much you'll want to have invested by the time the bottom is reached – whenever that is – and spend part of it today. **Stocks may turn around and head north, and you'll be glad you bought some. Or they may continue down, in which case you'll have money left (and hopefully the nerve) to buy more. That's life for people who accept that they don't know what the future holds.**

But no one can tell you this is *the* time to buy. Nobody knows.

March 3, 2020

Legal Information and Disclosures

Memo to: Oaktree Clients Only

From: Howard Marks

Re: Latest Update

I'm going to do all I can to provide information and views throughout this crisis, albeit perhaps without the kind of narrative or literary flourish I usually try for.

Flattening the Curve

The spread of the virus has been described as "exponential." Most people use this word without understanding precisely what it means. In short, exponential growth is the real-world version of what people in our business refer to as compounding. In other words, there's a growth percentage, and the parameter in question increases by that percentage every period. Thus **the rate of growth is constant, but the magnitude of the increase grows in each period**. For years, we've talked about things on the Internet "going viral." This is what exponential growth means.

If the number of daily new cases grows at a constant 10% (almost certainly a substantial understatement in the current case), and we start with 100 new cases on day 1, there will be 110 new cases on day 2; 121 on day 3; 133 on day 4; and 146 on day 5. The ultimate potential number of daily new cases is ugly. If the number of new cases continues to grow at 10% per day, there will be 1,745 new cases on day 31. (I'm very sorry to have to write about a number like that.)

Short-term success in fighting the virus isn't described in terms of eliminating the disease but rather "flattening the curve." In other words, (a) reducing the growth rate will result in a smaller increase in new cases each day (but still an increase), and (b) making the growth rate negative means there will be fewer new cases each day than the day before (but still new cases).

Observers seem to be working under the assumption that, sooner or later, "the curve will be flattened and then bent downward," meaning the disease will be controlled and perhaps disappear in three to six months. The reasons for optimism in this regard are as follows:

- People will isolate increasingly. The closures of schools, businesses and gathering places will help in this regard.
- Testing will allow us to identify those with the disease and separate them from the healthy population.
- The disease will fade when warm weather sets in (other epidemics that have appeared in recent decades have proved seasonal in this way).
- A preventive vaccine or therapeutic medication will be developed and approved.

Of course, no one knows whether or when these things will happen. But we can hope that the combination will limit the disease to the next three to six months as described above.

Short-Term Response

It's clear that strong actions are essential in order to halt or reverse the rising trend in the number of new coronavirus cases. Things we've seen in other countries include:

- Not suggesting, but ordering people to desist from going out, gathering and socializing.
- Imposing punishment for stepping over the threshold of their homes.
- Prohibiting movement on the part of people who have been diagnosed, and tracking their movement through cell phones.

There seems to be no doubt about the fact that success in flattening the curve comes best from identifying the people who have the disease and preventing them from passing it on to others. Thus the battle against the virus may bring public health considerations into conflict with civil liberties. It's "un-American" to restrict people's movements, but so far the American spirit of independence seems to be allowing some people to justify maintaining their usual behavior. **Rules may be required, not just warnings, suggestions and encouragement.** Restrictions will increase our chances of winning the war. People should not be surprised to see them, although their promulgation may come as a shock.

Likewise, people coming together to do business would prolong and exacerbate the epidemic. The more businesses that close, the more success we're likely to have against the disease. In addition, the fact that closings reduce the spread should alleviate the flow of patients to doctors and hospitals, improving the health system's ability to help sufferers. But, of course, the impact on individuals and the economy will be painful.

Unavoidable Pain

The news in the near term is unlikely to be good; instead it'll probably include:

- Business closures
- Job losses
- Supply-chain disruption
- Shortages of life's necessities, stemming from reduced production and distribution difficulties
- Challenges to the health system

Many businesses have been ordered to close (e.g., restaurants and bars). Some have seen their revenues evaporate (e.g., airlines, hotels and theaters). All of these things will cause job losses, with a particularly heavy impact on lower-income workers.

On March 17, Treasury Secretary Mnuchin warned that failure of the government to take appropriate action could take the U.S. unemployment rate to nearly 20% (by way of comparison, it reached 25% in 1933, during the Great Depression, and hit 10% as a result of the Global Financial Crisis). Regardless of the action taken, it seems sure to rise substantially from the 50-year low of 3.5%.

In recent years observers have made a big thing out of the fact that a large percentage of Americans would be unable to respond to a $400 emergency. There's some disagreement as to whether it's true, but clearly many people don't have much money in the bank. Where will they get money to buy essentials if they lose their jobs? The government is highly likely to distribute cash, but the speed and adequacy remain to be seen.

In coming weeks we are likely to see over-taxed hospitals; shortages of beds, ventilators and supplies; triage of care based on patients' age and health; infection among health professionals; and rising numbers of fatalities. There's no question that the health system is underprepared; the question is how much preparedness can be improved. I find it hard to believe the short-term news will be good.

In all these ways and more, the early news is bound to be bad. I think that's indisputable. The only good news in this regard would be if it doesn't reach the levels people expect and fear.

Fiscal and Monetary Actions

- The Fed has cut the short-term interest rate to zero – including a record emergency cut of 100 basis points on Sunday, March 15 – but unfortunately the total reduction has been only 150 basis points, whereas past rate-cut programs have amounted to roughly 500 basis points.

- The Fed and Treasury have taken other extraordinary actions to aid market functioning and financial system liquidity. The commercial paper market will be supported. Tax holidays and asset purchases are possible.

- Banks are likely to be hard-hit as a result of borrowers' defaults or moratoria on customers' payments. Thus we're highly likely to see steps designed to bolster the solvency of financial institutions and the availability of credit. Since banks need equity, dividends could be prohibited/discouraged.

Economists and forecasters are still plentiful – the challenging environment hasn't created a shortage there – and each one has an opinion. I never know which ones are right, but I find myself drawn to the views of Conrad DeQuadros of Brean Capital:

> In addition to Sunday's actions [cutting rates and initiating asset purchases], the alphabet soup of liquidity facilities is back with the relaunch of the Commercial Paper Funding Facility and the Primary Dealer Credit Facility yesterday. With the PDCF, dealers can even pledge equities to the Fed, with only a 16% haircut, and receive a 90-day loan at 0.25%. Non-investment grade corporate debt gets a 20% haircut.
>
> We also have continued actions by the Fed to encourage discount window loans. A key difference between now and 2008 is the speed with which the Fed is launching these facilities. In 2008, the PDCF was rolled out in March, the CPFF in October, and the first round of Large-Scale Asset Purchases in November. In this episode, we have rates slashed to the zero-lower bound, massive asset purchases, discount window actions (including regulatory guidance), the CPFF, the PDCF—all in a

matter of days. The speed with which COVID-19 events are unfolding is astonishing, but so is the speed of the Fed's response to financial strains.

The Fed is in "whatever it takes" mode. Fiscal authorities will likely follow suit (especially when next week's unemployment claims reading is a multiple of the highest reading we have ever seen in the past). The ECB joined the parade tonight.

All these are appropriate actions. Hopefully we'll see benefits from them and more. The Fed and Treasury will do everything they think might help. Clearly there's little interest in abstaining simply because expenditures will add to the national deficit and debt.

However, it's unfortunate that there was no appetite for refraining from stimulus and restocking the tool kit during the period of prosperity that prevailed in recent years. No one knows whether that failure will inhibit the monetary and fiscal response. But I wish (for example) that we were cutting short rates from 5.0%, not 1.5%.

<u>Market Behavior</u>

A few observations regarding the markets:

It's easy to say that something approaching panic is present in the markets. We've seen record percentage declines several times within the last month (exceeded since 1940 only by Black Monday – October 19, 1987 – when the S&P 500 declined by 20.4% in a day). This week and last included down days as follows: -7.6%, -9.5%, -12.0% and -5.2% yesterday. These are enormous losses.

However, it's worth noting that every one of those declines was followed by similar gains: +4.9%, +9.3% and +6.0% (before a small gain today). Given that almost all of the biggest down days in the last 80 years were followed by up days, so far the strategy of "buy the dips" has continued to be in favor. That's fine as far as it goes, but it has nothing to do with fundamental improvement. **What this tells me is that optimism still hasn't been entirely eradicated and replaced by capitulation. Typically, the bottom is reached only when optimism is nowhere to be found.**

On the other hand, there has been a rush to cash. Both long positions and short positions have been closed out – a sure sign of chaos and uncertainty. Cash in money market funds has increased substantially. This doesn't tell us anything about fundamentals, but the outlook for eventual market performance is improved:

- the more people have sold,
- the less they have left to sell, and
- the more cash they have with which to buy when they turn less pessimistic.

This is a good time to point out that, thus far in this episode, there's additional evidence that there's no such thing in the investment world as a sure thing, magic potion or silver bullet:

- I find it interesting that the price of gold – historically considered the greatest source of protection again tough times – has declined several percent over the last month. Here's the headline of a story from a gold site: "Gold prices sharply down as dread pervasive in marketplace." It wasn't supposed to work that way.

- Bitcoin, which partisans had said would serve as a safe harbor in times of crisis, may be down more than any other "asset class." (I apply that term to Bitcoin advisedly.) It's lost 47.6% over the last month, from $10,188 to $5,337.
- Risk-parity funds, which were designed to do well in most environments, experienced double-digit losses in February.
- Even the world's greatest algorithmic fund – which sports a fabulous long-term record – is reported to have suffered a loss of several percent last month.

Of course this is a short, chaotic period, but we can say that so far, the evidence of a miracle investment is lacking. Nothing new here.

To wrap up, I'll share some color from Justin Quaglia, one of our debt traders:

> After two days of a basically stalled, but stressed market, we "finally had the rubber band snap." Forced sellers (needing to sell for immediate cash flow needs) brought the market lower in a hurry. We opened 3-5 points lower, and the Street was again hesitant to take risk (from their couch/kitchen table/living room/weekend house) so risk only transferred into a bid from another market participant. Clearing levels quickly became 6-8 points lower.
>
> One of the brokers said it was flat-out mayhem . . . and he was working from home! Imagine what an actual trading floor would have been like. It basically became "duck and cover" if you were a market maker, as their risk-taking abilities are being hindered by the C-suite. Beside immediate needs, investors sold to prepare for quarter-end redemptions, FX movements, and to fund margin calls. Short settlements were rampant, and larger blocks cleared in high-quality BB credits. Most people don't even want to guess what the mark is on CCC risk. This ultimately ended up being the first real day of panic we have seen in a long time.

We're never happy to have the events that bring on chaos, and especially not the ones that are underway today. But it's sentiment like Justin describes above that fuels the emotional selling that allows us to access the greatest bargains.

<u>Oaktree Asset Classes</u>

To give you an indication of what has happened to date in U.S. credit, I'm going to provide data on prices, yields and performance as of yesterday's close. This information will be to be out of date by the time it reaches you, but hopefully it will still be useful.

(As of the close, March 18)	Average Price	Average Yield	Average Yield Spread	Performance Feb 19-Mar 18
High Yield Bonds ex-energy	88.42	8.9%	787 bps	(13.9)%
High Yield Bonds with energy	83.06	10.0	901	(17.2)
Senior Loans	81.57	9.6	874	(15.1)
BB CLOs	74.24	12.4	1,135	(20.7)

Yields and yield spreads have increased significantly (which is another way of saying there's been a lot of damage done). The price declines have been substantial, but the increase in yield for each point of price decline tends to put on the brakes. A yield of 9%, 10% or 12% is impressive in a world of 1% Treasurys, and thus tends to slow the fall. Declines to date of 15-20% for the bond and loan indices have brought substantial losses to holders, but also vastly improved opportunities for new investment.

* * *

What do we know? Not much other than the fact that asset prices are well down, asset holders' ability to hold coolly is evaporating, and motivated selling is picking up. I'll sum up my views simply – since there's nothing sophisticated to say:

- **"The bottom" is the day before the recovery begins. Thus it's absolutely impossible to know when the bottom has been reached . . . ever. Oaktree explicitly rejects the notion of waiting for the bottom; we buy when we can access value cheap.**

- **Even though there's no way to say the bottom is at hand, the conditions that make bargains available certainly are materializing.**

- **Given the price drops and selling we've seen so far, I believe this is a good time to invest, although of course it may prove not have been the best time.**

- **No one can argue that you should spend all your money today . . . but equally, no one can argue that you shouldn't spend any.**

- **The more you want to garner potential gains and don't mind mark-to-market losses, the more you should invest here. On the other hand, the more you care about protecting against interim markdowns and are able to live with missing opportunities for profit, the less you should invest.**

But is there really an argument for not investing at all? In my opinion, the fact that we're not necessarily at "the bottom" isn't such an argument.

March 19, 2020

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The indices referenced herein are represented by: ICE BofA US High Yield Index, ICE BofA US High Yield Excluding Energy, Metals & Mining Index, Credit Suisse Leveraged Loan Index and J.P. Morgan CLO BB Post-Crisis Index.

Memo to: Oaktree Clients

From: Howard Marks

Re: Which Way Now?

In the last six weeks the markets have seen the best of times and the worst of times:

- From February 19 to March 23, the U.S. stock market saw the quickest meltdown in history, for a loss of 33.9% on the S&P 500. Then its 17.5% gain from Tuesday through Thursday of last week made for the best three-day stretch since the 1930s.

- Of the 21 trading days between February 27 and March 27, a total of 18 days saw moves in the S&P 500 of more than 2%: eleven down and seven up. They included the biggest daily percentage gain since 1933 and the second-biggest percentage loss since 1940 (exceeded only by Black Monday in 1987).

- From March 9 through March 20, issuing a new investment grade bond seemed inconceivable. Then, as our trader Justin Quaglia points out, last week's news of the government's rescue package enabled 49 companies to issue $107 billion of IG bonds. That made it the biggest week for issuance on record; part of the biggest month on record ($213 billion from 106 issuers); and part of the biggest quarter on record ($473 billion, up 40% from the first quarter of 2019). In fact, there was more issuance **last week** than in nine of the 12 **months** in 2019.

- Finally, on March 26, Justin wrote, **"It's hard to believe I used the words 'panic' and 'FOMO' within two weeks of each other."**

Looking at the above, it's important to note the degree to which people (and thus markets) seem to think long-term phenomena can change in the short run.

It's common knowledge that the coronavirus is still gaining ground in the U.S. and elsewhere; the economy is destined for a serious recession; leveraged entities have to worry about their sources of loans and liquidity; and the price of oil is among the very lowest since the 1973 OPEC embargo. But the prices of financial assets have moved down as well: appropriately, too much or too little? In other words, **we have to consider the outlook and the appropriateness of value, in the context of unprecedented uncertainty and the total absence of guidance from analogies to the past.**

There's no doubt about the ability of the government's and the Fed's massive cash injections to make things better in the short run, and certainly the market has treated them as sure winners. But I think it's important to take time out for a serious discussion of possible scenarios. Are this past week's remedies certain to work? Are the prior week's negatives really erased? **Which will win in the short and intermediate term: the disease, economic ramifications or Fed/Treasury actions?** To try to think about these things in a responsible way, I've decided to try cataloging the optimistic and pessimistic elements.

The Positive Case

No one thinks things are good right now, but the optimist's view is built around the early cessation of bad news and the arrival of better news in the not-too-distant future. Here are the components. (As you know, I usually avoid using macro forecasts and never make my own. I will borrow from others for the purposes of exposition in this memo, but not because I have reason to believe they're correct):

- The earliest countries to contract the virus have shown good progress. The reported data on their new cases has flattened, and in South Korea, more people are being released from the hospitals than are entering. Hermann Dambach, head of our Frankfurt office, reports that the numbers are improving in Italy, Germany and Austria.

- Every forecast I've seen assumes **the virus will be brought under control within three months or so.** The curve is flattened and then turned downward. The virus is contained and then eliminated.

    - Testing identifies those infected, and isolation/quarantine keeps them from infecting others.
    - Herd immunity develops, reducing the number of people capable of transmitting the disease.
    - Warmer weather causes the disease to recede.
    - Treatments are found that aid recovery.
    - A vaccine is developed.

- **The negative impact of the disease on the economy will be sharp but brief.** The term "V-shaped" dominates most forecasts, both between Q2 and H2 and between 2020 and 2021. Thus, for example, one forecaster who has the earnings of the S&P 500 companies down 120% in Q2 thinks they may rise roughly 80+% in Q3 on a quarter-over-quarter basis (that is, to down just 20% from 2019) and then rise by a further 50% in Q4. And after a decline of 33% in 2020, earnings will rise by 55% in 2021 and exceed what they were in 2019.

- Telling people to stay home – and thus causing businesses to close – is the economic equivalent of putting a patient into a coma to facilitate curing a serious disease. **The government will provide life support to the economy during the coma and bring the patient out of the coma after the cure has been effected.**

  The economic recovery will be abetted by better news about the disease, but the improvement will mainly be the result of the success of the Fed/Treasury package of rescue and stimulus. These organizations have announced unprecedented expenditures and have indicated that they'll do whatever else it takes. Actions that were taken after months of deliberation in the Global Financial Crisis have been rolled out in the early weeks of the current episode. Further steps are likely to include everything anyone can think of and be unconstrained as to amount.

- The banks are much less vulnerable than they were during the Global Financial Crisis, with only a third of the leverage. Thus concerns for the health of the overall financial system are greatly reduced.

- The U.S.'s effective private sector will supplement the public health efforts of government, producing massive amounts of supplies and equipment, and developing testing, treatments and vaccines.

- The price declines of securities will draw in buyers, and ample capital is available in the form of dry powder in funds.

When I read the more positive views regarding the current episode, I can't help but think back to my favorite newspaper headline, which included the phrase **"Bankers Optimistic."** Usually the case, perhaps, but it's worth noting that the story in question was published on October 30, 1929, reporting on the prior day's stock market crash. On that day of optimism, the Great Depression still had eleven years to run.

The Negative Case

I always say we have to be aware of and open about our biases. I admit to mine: I'm more of a worrier than a dreamer. Maybe that's what made me a better credit analyst than equity analyst. On average I may have been more defensive than was necessary (although somehow I was able to shift to aggressive action when crisis lows were reached during my career). Thus it shouldn't come as a surprise today that my list of cons is longer than my pros (and I will elaborate on them at greater length).

- **I'm very worried about the outlook for the disease, especially in the U.S.** For a long time, the response consisted of suggestions or advice, not orders and rules. I was particularly troubled last weekend by pictures of college kids on the beach during spring break, from which they would return to their communities. The success of other countries in slowing the disease has been a function of widespread social distancing, testing and temperature-taking to identify those who are infected, and quarantining them from everyone else. The U.S. is behind in all these regards. Testing is rarely available, mass temperature-taking is non-existent, and people wonder whether large-scale quarantining is legal.

    - The total number of cases in the U.S. has surpassed both China's and Italy's and is still rising rapidly (and is likely understated due to under-testing).
    - The number of deaths doubled from 1,000 to 2,000 between Thursday and Saturday.
    - From a recent tweet by Scott Gottlieb, MD, former commissioner of the FDA: "I'm worried about emerging situations in New Orleans, Dallas, Atlanta, Miami, Detroit, Chicago, Philadelphia, among others. In China no province outside Hubei ever had more than 1,500 cases. In U.S. 11 states already hit that total. Our epidemic is likely to be national in scope."
    - The U.S. is under-equipped to respond in terms of hospitals, beds, ventilators and supplies. Under-protected doctors, nurses and first responders are at risk.

  I'm concerned that the number of cases and deaths will continue to rise as long as we fail to emulate the successful countries' actions. The health system will be overwhelmed. Triage decisions – including who lives and who dies – will have to be made. There will be a point where there doesn't seem to be an end in sight. **I'm afraid the headlines are going to get much uglier in this regard.**

- **The economy will contract at a record rate.** Many millions will be thrown out of work. People will be unable to patronize businesses. Not only will workers miss paychecks and businesses miss revenues, but businesses' physical output will tail off, meaning essentials like food may run short. Last week, 3.3 million new unemployment claims were filed, versus the previous week's 282,000 and the weekly record of 695,000. Prior to the government's actions, expectations included the following:

  - unemployment would return to 8-10%, and citizens would soon run short of cash;
  - businesses would close;
  - second-quarter GDP would decline from the year-ago level by 15-30% (versus a decline of 10% in the first quarter of 1958, the worst quarter in history);
  - some forecasters said the combined earnings of the S&P 500 companies would decline 10% in the second quarter, but that seems like a ridiculously small decline. **At the other end of the spectrum, I've seen a prediction that S&P earnings would decline by 120% (that's right: in total, the 500 companies would shift from profits to losses).**

  Government payments plus augmented unemployment insurance will replace paychecks for many workers, and aid to businesses will replace some of their lost revenues. But how long will it take to get these funds to recipients? How many should-be recipients will be missed? For how long will the aid continue? ($3,400 to a family of four won't last long.) What will it take to bring the economy back to life after it's been in a deep freeze? How fast will it recover? **In other words, is a V-shaped recovery a realistic expectation?**

- **It will be very challenging to resolve the conflict between social isolation and economic recovery.** How will we know whether the disease merits the cure? The longer people remain at home, the more difficult it will be to bring the economy back to life. But the sooner they return to work and other activities, the harder it will be to get the disease under control.

  First, the growth in the number of new cases each day has to be reduced. Next, the number of new cases has to begin to decline from one day to the next (that is, the growth rate has to turn negative). Then new cases have to stop appearing each day. (Of course, we'll need increased testing and mandatory quarantining for these things to occur.) As long as there are new cases each day, there are people who are infectious. If we send them back into the world and into contact with others, the disease will persist and spread. **And if we seize the opportunity provided by a decline in the number of new cases to resume economic activity, we risk a rebound in the rate of infection.**

- For the most part, we have companies whose revenues are down and companies whose revenues are gone. They can reduce their expenses, but because many of them are fixed (like rent), they can't reduce expenses as fast as revenues decline. That's why second-quarter profits will shrink, dry up or turn negative. Revenues may come back relatively soon for some industries (like entertainment), but less rapidly for others (like cruise lines).

- Many companies went into this episode highly leveraged. Managements took advantage of the low interest rates and generous capital market to issue debt, and some did stock buybacks, reducing their share count and increasing their earnings per share (and perhaps their executive compensation). The result of either or both is to increase the ratio of debt to equity. The more debt a company has relative to its equity, the higher the return on equity will be in good times . . . but also the lower the return on equity (or the larger the losses) in bad times, and the less likely it is to survive tough times. Corporate leverage complicates the issue of lost revenues and profits. Thus we expect to see rising defaults in the months ahead.

- Likewise, in recent years, the generous capital market conditions and the search for return in a low-interest-rate world caused the formation of leveraged investment entities. As with leveraged companies, debt increased their expected returns but also their vulnerability. **Thus I believe we're likely to see defaults on the part of leveraged entities, based on price markdowns, ratings downgrades and perhaps defaults on their portfolio assets; increased "haircuts" on the part of lenders (i.e., reduced amounts loaned against a dollar of collateral); and margin calls, portfolio liquidations and forced selling.**

  In the Global Financial Crisis, leveraged investment vehicles like Collateralized Mortgage Obligations and Collateralized Debt Obligations melted down, bringing losses to the banks that held their junior debt and equity. The systemic importance of the banks necessitated their bailouts (the resentment of which contributed greatly to today's populism). This time, leveraged securitizations are less pervasive in the financial system, and their risk capital wasn't supplied by banks (thanks to the Volcker Rule), but mostly by non-bank lenders and funds. Thus I feel government bailouts are unlikely to be made available to them. (As an aside, it's not that the people who structured these leveraged entities erred. They merely failed to include an episode like the current one among the scenarios they modeled. How could they? If every business decision had to be made in contemplation of a pandemic, few deals would take place.)

- Finally, in addition to the disease and its economic repercussions, we have one more important element: oil. **Due to a confluence of reduced consumption and a price war between Saudi Arabia and Russia, the price of oil has fallen from $61 per barrel at year-end to $19 today.** The price of oil was only slightly lower immediately before the OPEC embargo in 1973, and in the 47 years since then it has only been lower on two brief occasions. While many consumers, companies and countries benefit from lower oil prices, there are serious repercussions for others:

  - Big losses for oil-producing companies and countries.
  - Job losses: the oil and gas industry directly provides more than 5% of American jobs (and more indirectly), and it contributed greatly to the decline of unemployment since the GFC.
  - A significant decline in the industry's capital investment, which recently has accounted for a meaningful share of the U.S.'s total.
  - Production cuts, since consumption is down and crude/product storage capacity is running out.
  - The damage to oil reservoirs that results when production is reduced or halted.
  - A reduction in American oil independence.

As recounted above, the negative case encompasses rising numbers of infections and deaths, unbearable strain on the healthcare system, job losses in the many millions, widespread business losses and mounting defaults. If these things arise, investors are likely to shift from the optimism of last week to the pessimism that was prevalent in the rest of March. Contributing factors may include:

- negative psychology surrounding the combination of threats to the economy and life itself,
- fear of more, and
- a very negative wealth effect that depresses spending and investing.

The Government Programs

Last week the government enacted the CARES (Coronavirus Aid, Relief, and Economic Security) Act, with roughly $2 trillion of rescue and support. At the same time, the Fed will spend several trillion more to provide liquidity and buttress the financial system, and it has "committed to using its full range of tools." I will dispense with listing all the provisions of the CARES Act, and merely note that J.P. Morgan's description runs to eight pages. And as mentioned above, the list of ingredients and their magnitude are likely to grow.

I'll share a useful description of the economic situation and the government response from Conrad DeQuadros of Brean Capital, an economist I've taken to quoting:

> The CARES Act should not be thought of as fiscal stimulus but as an economic stabilization package. The collapse of economic activity in March 2020 is not a normal cyclical recession but is the result of a mandated "time out" of individuals and businesses by the government. Many of the provisions of the Act are designed to prevent the private sector from unraveling so that when the containment of the virus permits shutdowns to be lifted, activity can bounce back. . . .
>
> There is no avoiding recession because the output of airlines, hotels, restaurants, movie theaters, etc. is lost. However, these programs will support businesses so that when the virus permits the resumption of activity, we can see a sharp rebound in activity. Skilled labor was a scarce resource just one month ago and the key is to keep that labor and businesses connected. The support for businesses is really support for labor because if companies cannot pay workers from cash flows, the layoff figures will dwarf the numbers suggested by the latest jobless claims data.
>
> How effective will the measures be? In the latest quarter, labor compensation was $2.9 trillion (actual, non-annualized) and, to consider a purely illustrative number, a 20% (actual) drop in labor incomes amounts to $577 billion, which is about the magnitude of direct income support to households without considering the impact of support for businesses, which will head off a steeper decline in labor incomes. The fiscal package will unlock upward of $4 trillion of capital market support programs from the Fed. In addition there are the funds to help combat the spread of the virus and the sooner the virus can be contained, the more lives will be saved and the sooner America can get back to work. After a few months of being housebound, we suspect there will be plenty of pent up demand. The fiscal deficit in 2020 could be of the magnitude of $2.5 trillion but if the package fails, the recession would be longer and

deeper and the fiscal cost would be greater.

As always, I don't know which economists are right, but I'm happy to go with Conrad's summation.

Moving on from understanding the actions to date, I want to talk about the outlook for this effort. The government seems able, as Conrad says, to support and stabilize the economy. **In my simplistic view, I imagine it can print enough checks to replace every American worker's lost wages and every business's lost revenues. In other words, it can "simulate" the effect of the economy on incomes. But I have two questions: is that okay, and is it enough?**

First of all, as I mentioned above, we actually need the output of workers and businesses. If all businesses shut down, we won't have the things we need. These days, for example, people are counting on grocery deliveries and take-out food. But does anyone wonder where food comes from and how it reaches us? **The Treasury can make up for people's lost wages, but people need the things wages buy. So replacing lost wages and revenues will not be enough for long: the economy has to produce goods and services.**

Second, let's assume the government writes checks to replace wages and revenues forever, and that the economy continues to produce at a minimal but sufficient level, so the things we need materialize. What will be the long-term effect? **As with oil reservoirs, what will be the impact of long-term inactivity on the ability of the economy to produce? How long will it take to restart the economy and bring it back to its previous level of functioning?**

Lastly, what would be the effect of the Treasury continuing to add trillions of dollars each quarter to the deficit (which was running at $1 trillion even before the virus hit) **and of the Fed continuing to pump trillions more into the monetary system?** Last June, in my memo *This Time It's Different*, I discussed Modern Monetary Theory, which – to simplify – says federal deficits and debt don't matter. It's no longer just a theory; we have to deal with its implications now:

- What would be the effect of the above on the value of the dollar, and thus on the dollar's status as the world's reserve currency? (Of course, in this environment, other countries are likely to behave much the same as we do, meaning **the dollar may not be debased relative to other currencies**.)

- Might a reduction of the dollar's reserve-currency status make it harder for us to finance our deficits and raise the interest rates we have to pay to do so?

- Might money-printing to that degree bring on an increase in inflation?

- **Might a supply shock stemming from reduced global output of raw materials and finished goods add to the increase in inflation?** The factors that create inflation are truly mysterious, but these certainly seem like reasonable candidates, especially when combined.

Possibly without serious vetting and a conscious decision to adopt it, Modern Monetary Theory is here. Whether we like it or not, we'll get to see its impact much quicker than I had thought. (And remember, 100% of the "top scholars" polled by The University of Chicago Booth School of Business disagreed with some of MMT's claims).

Summing Up

Rather than reinvent the wheel – and to show you how others are viewing the situation (albeit in ways that parallel my view) – I'm going to share the workload by recycling the conclusion from a note I received from Jason Klein, CIO of Memorial Sloan Kettering:

> The bull case from here seems to be that monetary policy will work, fiscal policy will kick-in, valuations have reset, society will follow effective healthcare policies (e.g., social distancing) that will be effective, the real economy will adapt, and geopolitics will remain subdued. The bear market seems to be the flip side of each issue, and has the potential to be much darker as the prospects of a hot war with China, or even Iran, seem rather ominous. Across all recent events, I find it in some ways most interesting that Saudi Arabia chose to instigate a supply shock targeting U.S. shale at a moment when the demand for U.S. energy was already reeling from the demand-side shock from COVID-19 restrictions. It highlights the unpredictability of events. As you've said, nobody knows.

Richard Masson, my Oaktree co-founder and resident scold, might say Twitter isn't a worthy source, but nevertheless I want to include a concise summary tweeted by @yourMTLbroker:

> Bull case: everything opens in 6 weeks. The unemployed can go back to old jobs or as true Americans, bootstrap. Economy back to normal within 6 months. 2T $ in PE dry powder, low gas prices and 0% interest rates pour fuel onto on the economy. The roaring 20's mean the 2020's now.
>
> Bear case: Unemployment goes to 20%+. Everything does NOT go back to normal before at least a year or two, and in the meantime, there is a huge demand shock. The effects of the lockdown on businesses as well as the oil shock create depression-like conditions.

In the Global Financial Crisis, I worried about a downward cascade of financial news, and about the implications for the economy of serial bankruptcies among financial institutions. But everyday life was unchanged from what it had been, and there was no obvious threat to life and limb.

Today the range of negative outcomes seems much wider, as described above. **Social isolation, disease and death, economic contraction, enormous reliance on government action, and uncertainty about the long-term effects are all with us, and the main questions surround how far they will go.**

Nevertheless, the market prices of assets have responded to the events and outlook (in a very micro sense, I feel last week's bounce reflected too much optimism, but that's me). I would say assets were priced fairly on Friday for the optimistic case but didn't give enough scope for the possibility of worsening news. Thus my reaction to all the above is to expect asset prices to decline. **You may or may not feel there's still time to increase defensiveness ahead of potentially negative developments. But the most important thing is to be ready to respond to and take advantage of declines.**

The world will be back to normal someday, although today it seems unlikely to end up unchanged. **What matters most – in terms of both health and finances – is how we do in the interim. Stay safe!**

March 31, 2020

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Memo to: Oaktree Clients

From: Howard Marks

Re: Calibrating

I set a personal record by writing four memos in the month of March, responding to the rapidly unfolding coronavirus crisis. The task was made easier by the dearth of available data, meaning I was able to proceed without doing much research, mostly providing personal views.

In the first of the four memos, *Nobody Knows II*, I described the distinction made by Harvard epidemiologist Marc Lipsitch. He said there are (a) facts, (b) informed extrapolations from analogies to other viruses and (c) opinion or speculation. At that point, I thought the scientists were trying to make informed inferences, and there wasn't enough data regarding the novel coronavirus to enable them to turn those inferences into facts. I also noted that anything a non-scientist said was highly likely to be a guess. In that vein, I wrote the following to an Oaktree colleague last week: **"These days everyone has the same data regarding the present and the same ignorance regarding the future."** That pretty much sums up the state of affairs.

Most of what we have today is opinion, and much of it tilts either optimistic or pessimistic. The gulf in between is massive: if you read just the optimistic pieces, you'd think the virus will soon be eradicated and the economy brought back to health, and if you read just the negative ones, you'd think we're all done for.

In my opinion, the difference between most people's positive and negative views is likely to stem largely from their innate biases, and thus the data points they choose to overweight. Future scenarios comprise a large number of variables: today even more than usual. It's relatively easy to build a spreadsheet listing the many things that will contribute to the future and rate them as likely to turn out well or poorly. **But merely toting up the plusses and minuses won't tell you whether the future will be favorable or unfavorable. The essential element is figuring out which ones will be most influential. That's often where optimistic or pessimistic biases come in.** The optimist takes cheer from the favorable outlook for the positive data points, and the pessimist is depressed by the unpleasant possibilities for the negative ones . . . even if they're both working from the same underlying spreadsheet in terms of elements and ratings.

There's rarely such a thing as "knowing the future." But usually the future will be mostly like the past. This time, I think we can agree that the near-term future isn't likely to look much like it did a year ago. As I wrote last week in *Which Way Now?*, **we have to consider our situation "in the context of unprecedented uncertainty and the total absence of guidance from analogies to the past."**

Whereas the future is always uncertain, today the uncertainty is much greater than usual: the probability distribution governing future events is much wider and the tails much fatter. In fact, there are potential negatives (and perhaps positives) that few living people have faced before. Most of what we have is subjective opinion and interpretation.

I don't think I'm likely to have superior knowledge regarding the outlook for the virus, its impact on the economy, the success of Fed/government actions or the direction of oil prices. I organized and discussed the possibilities for each of these things in the March memos, but I'm unlikely to be a better predictor than anyone else.

I do, however, hope to help by discussing how you might think about your behavior in the current context. That's my subject today. But before I end with the conclusion I've reached, I want to summarize the relevant statements from the March memos. (As you'll see, I wrote two memos in mid-March that only went to Oaktree clients, although one was made available on our website a few days later.) Here we go (emphasis in the originals):

Nobody Knows II **– March 3**

We were still early in the crisis at this time, with just a handful of cases of the disease reported in North America. We were also early in the process of economic decline and market reaction. In fact, the S&P 500 was only down 13% from its level on February 19. In this first memo of the crisis, I struck a number of themes I would return to in the following weeks:

> These days, people have been asking me whether this is *the time* to buy. My answer is more nuanced: it's probably *a time* to buy. There can be no unique time to buy that we can identify. The only thing we can be sure of today is that stock prices, for example, are a lot lower in the absolute than they were two weeks ago.
>
> Buy, sell or hold? I think it's okay to do some buying, because things are cheaper. But there's no logical argument for spending all your cash, given that we have no idea how negative future events will be. What I would do is figure out how much you'll want to have invested by the time the bottom is reached – whenever that is – and spend part of it today. **Stocks may turn around and head north, and you'll be glad you bought some. Or they may continue down, in which case you'll have money left (and hopefully the nerve) to buy more. That's life for people who accept that they don't know what the future holds.**
>
> But no one can tell you this is *the* time to buy. Nobody knows.

An Update **– March 12 (to Oaktree clients only)**

A week and a half later, after we cancelled the Oaktree client conference and livestreamed instead, after Nancy and I had begun the social distancing that is still going on full-bore, and with the S&P 500 down 29%, I emphasized a contrarian theme, concluding that the damage done had created pronounced opportunities.

> As always, it's important to be conscious of the investment environment and behave like a contrarian. For years, investors thought conditions were good, and we at Oaktree believed that consequently, prices were high and markets were characterized by risky behavior. That's what made us cautious. Now the "flawless decade" is certainly over, and asset prices have been cut. The great contrarian, Warren Buffett is

famous for saying he likes hamburgers, and when hamburgers go on sale, he eats more hamburgers.

My roughly quarterly memos pale when compared to the output of Doug Kass, who writes at least daily. His March 11 note had a terrific title: "When the Time Comes to Buy, You Won't Want To." The best time to buy generally comes when nobody else will; other people's unwillingness to buy tends to make securities cheap. But the factors that render others averse to buying will affect you, too. The contrarian may push through those feelings and buy anyway, even though it's not easy. **As I put it, "All great investments begin in discomfort." One thing we know is that there's great discomfort today.**

Latest Update **– to clients March 19, on website March 24**

This memo was issued with the S&P 500 down 29% and within a few days of the low (down 34%) that would be reached on March 23. The panic we were observing, and the great purchases we made that week, convinced me to take a firmer tone in arguing for buying. I took the position that it would be a mistake to wait for an ascertainable bottom before doing so.

What do we know? Not much other than the fact that asset prices are well down, asset holders' ability to hold coolly is evaporating, and motivated selling is picking up. I'll sum up my views simply – since there's nothing sophisticated to say:

- "The bottom" is the day before the recovery begins. Thus it's absolutely impossible to know when the bottom has been reached . . . ever. Oaktree explicitly rejects the notion of waiting for the bottom; we buy when we can access value cheap.
- Even though there's no way to say the bottom is at hand, the conditions that make bargains available certainly are materializing.
- Given the price drops and selling we've seen so far, I believe this is a good time to invest, although of course it may prove not to have been the best time.
- No one can argue that you should spend all your money today . . . but equally, no one can argue that you shouldn't spend any.
- The more you want to garner potential gains and don't mind mark-to-market losses, the more you should invest here. On the other hand, the more you care about protecting against interim markdowns and are able to live with missing opportunities for profit, the less you should invest.

But is there really an argument for not investing at all? In my opinion, the fact that we're not necessarily at "the bottom" isn't such an argument.

Which Way Now? **– March 31**

Word of the Fed/Treasury response to the economic difficulty emerged on March 24 and was immediately accepted as likely to succeed. By the time the program was enacted, the stock market had experienced a rally on March 24-26 that delivered the best three-day gain since the 1930s, leaving the S&P 500 down just 24%.

> . . . the market prices of assets have responded to the events and outlook (in a very micro sense, I feel last week's bounce reflected too much optimism, but that's me). I would say assets were priced fairly on Friday [March 27] for the optimistic case but didn't give enough scope for the possibility of worsening news. Thus my reaction to all the above is to expect asset prices to decline. **You may or may not feel there's still time to increase defensiveness ahead of potentially negative developments. But the most important thing is to be ready to respond to and take advantage of declines.**

My message wasn't uniform across the four memos, but there were some common threads.

- My observations waxed and waned, in particular as security prices did.
- I never urged selling, as I thought a fair bit of the damage had been done. In other words, it was probably too late to make portfolios less risky.
- I talked about the reasonableness of buying – to varying degrees – primarily in response to the extent securities had cheapened.
- I never said it was *the* time to buy (or that it wasn't). I urged an incremental approach, not all-in or all-out.
- **The most consistent observation was probably that not buying anything at the new low prices would be a mistake.**

The vagueness and variation of the message summarized above make it less than concrete and perhaps less than satisfying for someone who's looking for unequivocal advice. **In my opinion, however, there's simply no room for certainty in investing, and today more so than usual.**

Portfolio Positioning

One of the benefits I derive from writing my memos is that the more I work on a memo about something, the more it comes into focus. Thus the four March memos gave me a great opportunity to ponder what the events imply for investment behavior. I'm glad to say I've reached a conclusion on that subject. I feel strongly that it's right . . . and I fully expect to amend it in the future. (To set the scene, the next few paragraphs will be repeat things I've said in the past.)

In recent years I've become more and more convinced that the fund manager's most important job for the intermediate term isn't to decide the allocation of capital between stocks versus bonds; U.S. versus foreign; developed markets versus emerging; large-cap versus small-cap; high-quality versus low-quality; or growth versus value. And it isn't choosing among strategies, funds and managers. **The most important job is to strike the appropriate balance between offense and defense.** Those other things won't help much if you get offense/defense wrong. And if you get offense/ defense right, those other things will take care of themselves.

One way to think about the balance between offense and defense is to consider the "twin risks" investors face every day: the risk of losing money and the risk of missing opportunity. At least in theory, you can eliminate either one but not both. Moreover, eliminating one exposes you entirely to the other. Thus we tend to compromise or balance the two risks, and every individual investor or institution should develop a view as to what their normal balance between the two should be.

Next, investors might consider trying to calibrate their balance over time in response to conditions in the environment – thus the title of this memo:

- The more propitious the environment – the more prudently other investors are behaving, the better the outlook for earnings, and the lower security prices are relative to intrinsic value or "fundamentals" – the more an investor might want to shift toward offense.
- On the other hand, the more precarious the environment – the more others are embracing risk, the more headwinds to profits there are, and the higher valuations are – the more an investor might choose to emphasize defense.

In recent years, it's been my view that the investment world was marked by the following characteristics:

- more uncertainty than usual,
- extremely low prospective returns,
- full to high asset prices, and
- pro-risk behavior on the part of investors reaching for higher returns.

These things told me the world was a risky, low-return place, and for that reason Oaktree's mantra has been "move forward, but with caution." We've generally been fully invested, but with even more than our usual caution. We made a decision to overweight defense, and there were years in which higher risk produced higher returns, and we paid a price for being cautious. We had no idea what the catalyst would be that turned the risk into loss, and there were no obvious candidates. But we felt the world was a risky place, exposed to negative developments. Now we know the catalyst, and now portfolio risk has produced loss. That's the background.

As described above, I felt the uncertain, low-return environment called for defense to be over-weighted relative to offense. Now, however, as opposed to the conditions of 2, 6, 12 or 24 months ago:

- the risks in the environment are recognized and largely understood,
- prospective returns have turned from paltry to attractive (for example, the average yield on high yield bonds ex. energy has gone from 3½% to almost 9%),
- security prices have declined, and
- investors have been chastened, causing risk-taking to dry up.

Given these new conditions, I no longer feel defense should be favored. Yes, the fundamentals have deteriorated and may deteriorate further, and the disease makes for risk (remember, I'm the one who leans toward the negative case). **But there's a big difference between a market where no one can find a flaw and one where people have given up on risk-taking. And there's a big difference between one that's priced for perfection and one that allows for bad outcomes.**

Cautious positioning in recent years has served its purpose. Investors who favored defense over offense have experienced smaller losses this year, have the satisfaction that comes from relative outperformance, and are able to spend more of their time looking for bargains than dealing with legacy problems. **Thus, I feel it's a time when previously cautious investors can reduce their overemphasis on defense and begin to move toward a more neutral position or even toward offense** (depending on how sure they want to be of grasping early opportunities).

I'm not saying the outlook is positive. I'm saying conditions have changed such that caution is no longer as imperative. With part of the crisis-related losses having already taken place, I'm somewhat less worried about losing money and somewhat more interested in making sure our clients participate in gains. **My 2018 book, *Mastering the Market Cycle*, carries the subtitle *Getting the Odds on Your Side.* In that vein, I now feel the odds are more in investors' favor or, at a minimum, somewhat less against them. Portfolios should be calibrated accordingly.**

<u>Looking for the Bottom</u>

Before I close, just a word on market bottoms. Some of the most interesting questions in investing are especially appropriate today: **"Since you expect more bad news and feel the markets may fall further, isn't it premature to do any buying? Shouldn't you wait for the bottom?"**

To me, the answer clearly is "no." As mentioned earlier, we never know when we're at the bottom. A bottom can only be recognized in retrospect: it was the day before the market started to go up. **By definition, we can't know today whether it's been reached, since that's a function of what will happen tomorrow. Thus, "I'm going to wait for the bottom" is an irrational statement.**

If you want, you might choose to say, "I'm going to wait until the bottom has been passed and the market has started upward." That's more rational. However, number one, you're saying you're willing to miss the bottom. And number two, one of the reasons for a market to start to rise is that the sellers' sense of urgency has abated, and along with it the selling pressure. That, in turn, means (a) the supply for sale shrinks and (b) the buyers' very buying forces the market upward, as it's now they who are highly motivated. These are the things that make markets rise. **So if investors want to buy, they should buy on the way down. That's when the sellers are feeling the most urgency and the buyers' buying won't arrest the downward cascade of security prices.**

Back in 2008, on the heels of Lehman Brothers' September 15 bankruptcy filing, Bruce Karsh and his team embarked on an unprecedented program to buy the debt of companies in distress. They invested an average of roughly $450 million per week over the last 15 weeks of the year, for a total of nearly $7 billion. Debt prices collapsed throughout that period, and they continued to fall in the first quarter of 2009 (along with the stock market). But because the hedge funds facing withdrawals had been gated – and because the leveraged, securitized vehicles that would melt down had all been liquidated – large amounts ceased to be for sale after year-end. In short, if we hadn't bought in the fourth quarter, we would have missed our chance.

The old saying goes, "The perfect is the enemy of the good." Likewise, waiting for the bottom can keep investors from making good purchases. **The investor's goal should be to make a large number of good buys, not just a few perfect ones.** Think about your normal behavior. Before every purchase, do you insist on being sure the thing in question will never be available lower? That is, that you're buying at the bottom? I doubt it. You probably buy because you think you're getting a good asset at an attractive price. Isn't that enough? And I trust you sell because you think the selling price is adequate or more, not because you're convinced the price can never go higher. **To insist on buying only at bottoms and selling only at tops would be paralyzing.**

On the contrary, I gave this memo the title *Calibrating* because of my view that a portfolio's positioning should change over time in response to what's going on in the environment. As the environment becomes more precarious (with prices high, risk aversion low and fear lacking), a portfolio's defensiveness should be increased. And as the environment becomes more propitious (with prices low, risk aversion high and fear prevalent), its aggressiveness should be ramped up. **Clearly, this process is one of gradual readjustment, not a matter of all-or-nothing. It shouldn't be the goal to do this only at bottoms and tops.**

So it's my view that waiting for the bottom is folly. What, then, should be the investor's criteria? **The answer's simple: if something's cheap – based on the relationship between price and intrinsic value – you should buy, and if it cheapens further, you should buy more.**

I don't want to give the impression that it's easy to buy while prices are tumbling. It isn't, and in 2008, Bruce and I spent a lot of time supporting each other and debating whether we were buying too fast (or too slow). The news was terrible, and for a good while it seemed as if the vicious circle of financial institution meltdowns would continue unchecked. **Terrible news makes it hard to buy and causes many people to say, "I'm not going to try to catch a falling knife." But it's also what pushes prices to absurdly low levels.** That's why I so like the headline from Doug Kass that I referred to above: "When the Time Comes to Buy, You Won't Want To." **It's not easy to buy when the news is terrible, prices are collapsing and it's impossible to have an idea where the bottom lies. But doing so should be the investor's greatest aspiration.**

As for the current episode, here's some data from Gavekal Research's Monthly Strategy piece for April, bearing on the question of whether the bottom was passed in March:

> . . . markets rarely clear after one massive decline. In 15 bear markets since 1950, only one did not see the initial major low tested within three months . . . In all other cases, the bottom has been tested once or twice. Since news-flow in this crisis will likely worsen before it improves, a repeat seems likely.

And here's some data from my son Andrew regarding the movements of the S&P 500 index around the time of the last two big crises. The first and second declines were followed by substantial rallies . . . which then gave way to even bigger declines:

9/1/00 - 4/4/01	-27%
4/4/01 - 5/21/01	+19%
5/21/01 - 9/21/01	-26%
9/21/01 - 3/19/02	+22%
3/19/02 - 10/9/02	-33%

10/9/07 - 3/10/08	-18%
3/10/08 - 5/19/08	+12%
5/19/08 - 11/20/08	-47%
11/20/08 - 1/6/09	+25%
1/6/09 - 3/9/09	-27%

Gavekal's and Andrew's data tell us markets rarely rally in a straight line. Rather, their movements represent a continuous tug-of-war between the bulls and the bears, and the result rarely goes in just one direction. After the optimistic buyers of the initial dips have responded to the low prices and bought, the pessimists find the new, higher prices unsustainable and engage in another round of selling. And so it goes for a while. Thus, as Oaktree's Wayne Dahl points out, it took until mid-May 2007, or almost seven years, for the stock market to regain the September 2000 highs, and it took until mid-March 2013, or five and a half years, to regain the highs of October 2007.

The bottom line for me is that I'm not at all troubled saying (a) markets may well be considerably lower sometime in the coming months and (b) we're buying today when we find good value. I don't find these statements inconsistent.

April 6, 2020

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Memo to: Oaktree Clients

From: Howard Marks

Re: Knowledge of the Future

As I showed by using it again in last week's memo, I was impressed by the observation of Marc Lipsitch, Harvard epidemiologist, that there are (a) facts, (b) informed extrapolations from analogies to other viruses and (c) opinion or speculation. He said it in connection with the novel coronavirus, but I've been thinking about its relevance to investing.

In the past, I've defined investing as the act of positioning capital so as to profit from future developments. I've also mentioned the challenge presented by the fact that there's no such thing as knowing what future developments will be. This is the paradox we must deal with.

To follow Lipsitch's analysis, in our world of investing:

- there are few if any facts regarding the future,
- the vast majority of our theorizing about the future consists of extrapolating from past patterns, and
- a lot of that extrapolation – and just about all the rest of our conclusions – consists of what Lipsitch calls opinion or speculation and what I call guesswork. (George Bernard Shaw said, "All professions are conspiracies against the laity." Thus the rules of the investment profession seem to require that its members describe their views about the future using high-sounding terms like "analysis," "assessment," "projection," "prediction" and "forecast." Rarely do we see the word "guess.")

Last week, in *Calibrating*, I mentioned having written to an Oaktree colleague that, "These days everyone has the same data regarding the present and the same ignorance regarding the future." I chose the title of this memo because it's such an oxymoron: there's practically no such thing as meaningful knowledge regarding the future investment environment. Thus, this memo will be about some things people think they know but may not.

Extrapolating from the Past

We use extrapolation from the past as the best way to deal with the future. If not for the ability to research past patterns and apply them to decisions regarding the future, we'd have to reach a new conclusion every day about every future possibility. So, for example, in investing we study typical past cycles, the exceptions from the norm, and details like the up-and-down pattern that's part of most rallies, as described last week in *Calibrating*.

But blind faith in the relevance of past patterns makes no more sense than completely ignoring them. There has to be good reason to believe the past can be extrapolated to the future; as Lipsitch says, it has to be informed extrapolation. And that brings me to the current episode.

What does the U.S. see today?

- one of the greatest pandemics to reach us since the Spanish Flu of 102 years ago,
- the greatest economic contraction since the Great Depression, which ended 80 years ago,
- the greatest oil-price decline in the OPEC era (and, probably, ever), and
- the greatest central bank/government intervention of all time.

The future for all these things is clearly unknowable. We have no reason to think we know how they'll operate in the period ahead, how they'll interact with each other, and what the consequences will be for everything else. **In short, it's my view that if you're experiencing something that has never been seen before, you simply can't say you know how it'll turn out.**

In my last two memos, I stressed my conviction that there's no "informed" way to choose between the positive and negative scenarios we face today, and that most people decide in a way that reflects their biases. While searching the Internet for the source of the quote above about professions, I came across something that I think supports my view that most people reach conclusions for reasons that are questionable:

> An ignorant mind is precisely not a spotless, empty vessel, but one that's filled with the clutter of irrelevant or misleading life experiences, theories, facts, intuitions, strategies, algorithms, heuristics, metaphors, and hunches that regrettably have the look and feel of useful and accurate knowledge. This clutter is an unfortunate by-product of one of our greatest strengths as a species. We are unbridled pattern recognizers and profligate theorizers. Often, our theories are good enough to get us through the day, or at least to an age when we can procreate. But our genius for creative storytelling, combined with our inability to detect our own ignorance, can sometimes lead to situations that are embarrassing, unfortunate, or downright dangerous – especially in a technologically advanced, complex democratic society that occasionally invests mistaken popular beliefs with immense destructive power (See: crisis, financial; war, Iraq). ("We Are All Confident Idiots," David Dunning, Professor of Psychology, University of Michigan, *Pacific Standard* magazine, October 27, 2014)

In other words, we may not be able to know the future, but that doesn't keep us from reaching conclusions about it and holding them firmly.

Getting Back to Normal

One of the greatest uncertainties we face today surrounds the outlook for the economy. The optimists expect a V-shaped recovery, and a great deal is riding on the question of whether it'll materialize. It depends on when America will go back to work, and that, in turn, depends to a great extent on the trend in infections.

Early on, we were told the growth of the disease would be "exponential." We learned what that meant – the number of new cases would grow from one day to the next by a constant percentage – and about the idea of "flattening the curve." Thus, in the language of investing, the number of cases would "compound." Because new cases would rise each day by a constant percentage, their number would increase as the fixed growth rate was applied to an expanding base.

In order to get the disease under control, the following progression has to take place:

- The growth in the number of daily new cases has to come in below expectations, meaning the rate of growth has to decline rather than remain constant.
- Then the number of daily new cases has to stabilize, meaning the rate of growth is declining.
- Then the number of daily new cases has to decline, meaning the rate of growth is negative.
- Then the number of daily new cases has to go to zero, meaning the disease has been stopped.

Different places around the world and in the U.S. are at different stages in this progression. There are places where the number of daily new cases is continuing to rise; places where the curve is flattening and the new cases are declining (e.g., trends are positive in U.S. cities that were beset early); and places that had good results early but are seeing rebounds as rules are relaxed and people start to return to their normal behavior. Here are a few of the questions that bear on the outlook for the curve:

- Will testing and contact mapping facilitate keeping infected people out of circulation?
- Will large numbers of asymptomatic infections impede the effort to isolate carriers?
- Will it be possible to test people to learn whether they've had the disease and developed antibodies, such that they can go out in public without fear of reinfection?
- Will herd immunity develop? Will it be permanent?
- Will the arrival of warm weather be helpful?
- Will a cure be developed?
- Will the virus morph into other forms, requiring new cures?
- Will a vaccine be developed, and when?

One of the thorniest questions remains how society and its leaders will make the trade-off between minimizing deaths from the virus and restarting the economy. In other words, at which step in the progression at the top of this page will the back-to-work message be delivered? The longer people stay at home and the economy remains shut down, the further the progression will be allowed to go, and the closer we'll get to containing the disease. Simultaneously, however, the more damage will be done to the economy and the harder it'll be to restart.

A decision to end the stay-at-home orders on May 1 rather than May 31 will be better for the economy in the short run, but it'll also send people into society while there are still infected people around, and thus it's likely to result in a "rebound" or "echo," as Hong Kong and Singapore have seen; in a re-steepening of the curve; and in further infections and deaths. **How will we make that trade-off? There's no algorithm for deciding whether to favor life for a few (or for thousands) versus economic improvement for millions.** On one hand, choosing the economy seems hard-hearted. On the other, we permit or even encourage many activities that result in large numbers of deaths, such as driving. Here's how renowned investor Edward Lampert put it in *The New York Sun* on April 6:

> Driving an automobile is risky. In 2018, the number of auto-related fatalities in the United States was 36,560, according to the National Highway Traffic Safety Administration. Yet we don't ban automobiles, nor do we impose a 10 mile an hour speed limit. Doing so would eliminate most of those deaths and injuries, but it would also adversely affect economic activity enabled by faster transportation of people and products.
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> Overall, the benefits of automobiles exceed the costs. Individuals knowingly assume the risks. Businesses compete to make money by reducing those risks. To deal with market failures and externalities, and to provide a certain minimum floor, we have regulatory mechanisms imposed by government to mitigate risks and compensate for losses.
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> These same approaches can be useful in guiding the public policy response to the coronavirus, showing the way to a middle ground that minimizes harm without excessive costs to either the economy or individual freedom. . . .
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> We need to get America back to work quickly. Businesses and individuals can adapt dynamically to intelligently guard their interests, seek opportunities, and make trade-offs. The government can provide the traffic signals and the safety standards. That approach to public health is consistent with a free and economically vibrant country, rather than in conflict with it. It's tested on our highways every day.

The last issue I want to raise on this subject surrounds the decisions each individual will have to make regarding the point in the progression of control at which they and their loved ones will cease practicing social distancing. Oaktree debt traders Justin Quaglia (who's been showing up in these memos a lot) and Sam Rotondo came up with a few questions on this subject:

Assuming the quarantine is lifted:

- when will you take your first flight? How will you react when the person next to you starts coughing?
- what has to happen to make you feel it's safe to send your child back to school?
- what will happen when everyone returns to work, allergy season begins, and a few of your colleagues begin to sound nasally and cough persistently?
- when you go out to dinner with your wife/husband/friend/family, do you want to be served by a waiter/waitress wearing a mask and gloves?

I'll add two more: If a test says you have immunity, will you stop social distancing and go back into public spaces while new infections are still being reported? And for us New Yorkers, when will you get back on the subway?

Questions like these suggest that a mere message from government is unlikely to get everyone to return to their former habits, including their jobs (if they have a choice). **Instead, the reopening of the economy is likely to be gradual and, until a vaccine is perfected or herd immunity is reached, subject to alternating periods of progress and retreat.**

Washington Goes to Battle

Over the last few weeks, the Fed, SEC and Treasury have announced an unprecedented program of stimulus, support, rescue and regulatory relief. They continue to bring new actions forward and expand the size and scope of existing ones. There's no reason to believe there's anything they won't do or any magnitude they won't exceed. I was among many who were worried a month ago about the limited scope of the Fed arsenal, given that the federal funds rate stood at only 1½% and most past rate-cutting programs ran to about 500 basis points. Now we see the vast extent of the Fed's potential toolkit.

On March 15, in announcing the second of two rate cuts totaling 150 basis points that took the short-term federal funds rate to nearly zero, Fed Chairman Jay Powell said the following: "We really are going to use our tools to do what we need to do here." (*Reuters*, March 16). Two weeks later, he elaborated on the Fed's intentions (emphasis added):

> Mr. Powell has made clear that **even with interest rates at zero, the Fed's firepower is limitless**. "When it comes to lending, we are not going to run out of ammunition," he said Thursday [March 26] in an interview on NBC's "Today" show. "That doesn't happen." (*The Wall Street Journal*, March 30)

Here are some excerpts from *Bulletin Intelligence's* April 10 recap regarding the Fed's actions (emphasis added):

> CNBC reports that the Federal Reserve has "dramatically expanded its efforts to save the economy, even adding junk bonds to the list of assets it can buy, as a wave of businesses are anticipated to have trouble surviving the expected recession." According to CNBC, "Stocks jumped, Treasury yields rose and the dollar sagged after the Fed said it would provide $2.3 trillion in programs that expand its operations to reach small and midsized businesses and U.S. cities and states." CNBC says **the Fed "expanded its corporate lending programs to take it into an entirely new area, including ETFs of companies that are rated below investment grade.** It had previously announced a program to buy investment-grade corporate debt and ETFs. It also will now accept triple-A-rated commercial mortgage-backed securities and collateralized loan obligations."
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> Bloomberg reports that "investors quickly bid up prices on corporate bonds and stocks after the announcement. High-yield debt was among the biggest gainers, with some of the largest ETFs tracking those bonds surging the most in a decade." According to Bloomberg, **"The nature of the Fed's actions pass the traditional boundaries of the central bank to purchase lower-rated debt and the credit of municipalities, raising questions about its future role."**
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> The Washington Post editorializes, **"The Fed is putting its balance sheet at the service of the private sector** for what we must hope is the shortest period absolutely necessary," but "it will be up to Congress to provide whatever needed funding – for health care, state budget relief and individual income support – lies beyond the Fed's ambit."

> **An editorial in the Wall Street Journal views the Fed's move as a misstep** that increases the Fed's exposure to risky assets [see page 8], and overlooks Main Street in favor of Wall Street. **The decision also poses a threat to the traditional concept of American capitalism, as the Fed and Treasury become the leading lenders to US businesses.**

There's no doubt in anyone's mind that there was a pressing need for a swift and pronounced response to the economic impact of the effort to combat the pandemic. Less than a month ago, Bruce Karsh and I were pondering the possibility of a global depression. We never hear about that topic anymore, and much of the discussion centers around whether 2019 GDP will be exceeded in 2021 or whether it'll take until 2022.

Now, instead of discussing depression, we wonder about the propriety and long-term impact of the various government actions. I don't intend to dissect the program emanating from Washington in detail, but I do want to raise some questions:

"Limitless" is an interesting word (see previous page). **Is the program really limitless? And is that okay?** The stimulus, loans, bailouts, benefits and bond buying that have been announced thus far add up to several trillion dollars. What are the implications of the resultant additions to the federal deficit and the Fed's balance sheet? To be facetious, the government could send every American a check for $1 million, at a cost of $330 trillion. **Would there be negative consequences from doing this, such as burgeoning inflation, a downgrade of U.S. creditworthiness or the dollar losing its status as the world's reserve currency?** If the answer is yes, is there a point below $330 trillion at which those ramifications might kick in? And if so, where? Could we be there already?

Obviously, what these government entities are doing is cushioning the financial impact of the economic deepfreeze. And as I mentioned on March 31 in *Which Way Now?*, they clearly have the ability to distribute enough money to make up for businesses' lost revenues and workers' lost wages. **But what'll be the impact on America of the loss of a substantial portion of the second quarter's production of goods and services? How will the economy rebound, and at what speed? If we have stops and starts, and if workers return gradually as suggested on page 4, is a V-shaped recovery still likely?** What'll be the effect if some unemployed workers who used to earn less than $1,200 per week can receive more than that in benefits?

Finally, I want to talk about the Fed's role and the impact of its behavior. Just two months ago, I attended a dinner with the president of one of the 12 Federal Reserve Banks. I asked him whether the Fed might adopt the tactic of buying corporate bonds, given the limited room for rate cuts. No, he said, it would only buy government and agency obligations. As mentioned above, a few weeks ago the Fed added investment grade corporates to its buying list, and last week it dropped down to include some high yield securities (BBBs downgraded to BB and some high yield ETFs).

It also gave regulatory relief to business developments companies, or BDCs, which buy or make loans to mid-size businesses. In order to help them avoid tripping limits on their activities, the Fed said they can value the loans on their books at December 31 prices. "The SEC is primarily trying to address the issue that a temporary markdown in the fair value of BDC portfolio companies could increase leverage above the regulatory maximum, thus limiting further lending by a BDC. As such, the SEC is allowing BDCs to use an adjusted portfolio value when calculating their asset coverage (leverage) ratio." (Keefe, Bruyette & Woods, April 9) **In other words, we're in a regulatory wonderland where there's no pretense that financial statements have to be accurate or current.**

I was particularly surprised by these latter actions. **What's the Fed's purpose in buying non-investment grade debt?** Does it want to make sure all companies are able to borrow, regardless of their fundamentals? Does it want to protect bondholders from losses, and even mark-to-market declines? Who'll do the buying for the government and make sure the purchase prices aren't too high and defaulting issuers are avoided (or doesn't anyone care)?

And why should the SEC provide relief to leveraged investment vehicles? If such an entity proves to be over-leveraged and sees its collateral marked down such that it's constricted or even liquidated, what's the loss to society? Why should leveraged investors – ostensibly not systemically important – be protected from pain?

In the aftermath of the Global Financial Crisis, the Fed and Treasury undertook a number of actions to encourage price discovery, rekindle risk-bearing and reopen markets. They worked well, their goals were accomplished, and the U.S. recovery from the GFC was swift and strong. (Of course, we can debate whether the willingness to bear risk snapped back too fast and too far.) But some of these things were done through encouraging the operation of market mechanisms, not direct action. Now bonds are being bought and rules waived. **Is there a point at which these things become undesirable?**

Most of us believe in the free-market system as the best allocator of resources. Now it seems the government is happy to step in and take the place of private actors. We have a buyer and lender of last resort, cushioning pain but taking over the role of the free market. When people get the feeling that the government will protect them from unpleasant financial consequences of their actions, it's called "moral hazard." People and institutions are protected from pain, but bad lessons are learned.

A company uses its cash and perhaps borrows more to repurchase its shares. A corporate acquiror chooses to use more leverage rather than less. Or the organizer of a REIT or CLO takes on more debt in order to amplify its returns. In each case, the chosen tactic will magnify profits if things go well, but it'll also magnify losses if things go poorly **and reduce the probability of surviving tough times**. If these parties get to enjoy the fruits of their actions when they're successful but are protected from loss when they fail, risk-taking is encouraged and risk aversion is suppressed.

There's an old saying – variously attributed – to the effect that "capitalism without bankruptcy is like Catholicism without hell." It appeals to me strongly. **Markets work best when participants have a healthy fear of loss. It shouldn't be the role of the Fed or the government to eradicate it.**

Some people argue these days that there's no way those who took on leverage that turned out to be excessive could have been expected to anticipate a pandemic and the resultant damage to the economy. Thus, the argument goes, the jam the government is rescuing them from "isn't their fault," meaning the bailout isn't unreasonable. As I wrote in *Which Way Now?*, I understand they aren't guilty of having ignored a likely risk. But unlikely (and even unforeseeable) things happen from time to time, and investors and businesspeople have to allow for that possibility **and expect to**

bear the consequences. In other words, they have to think like the six-foot-tall man hoping to get across the stream that's five feet deep *on average*. **I see no reason why financiers should be bailed out simply because the event they're being harmed by was unpredictable.**

Here's the reaction of *The Wall Street Journal* to last week's Fed actions (April 9; emphasis added):

> The big winners included non-investment grade corporate bonds and real-estate investment trusts that will now qualify for Fed programs despite their credit risk. High-yield and municipal bond prices also rose. Growth companies like Amazon, Intel and Nvidia fell or were flat, and the overall market reaction was underwhelming.
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> This reflects the priorities of the Fed's new lending facilities, and how far out on the risk curve it is going. Take the Term Asset-Backed Securities Loan Facility that the Fed first used in 2008 and that it revised last month. In 2008 TALF accepted only triple-A-rated securities and it made money on the loans. On Thursday the Fed said it will now accept much riskier credits including commercial mortgage securities and collateralized loan obligations.
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> **These are loan pools packaged into securities by Wall Street, which lobbied the Fed and Treasury hard for the TALF expansion. This means the Fed will in effect buy the worst shopping malls in the country and some of the most indebted companies. The opportunities for losses will be that much greater.** Treasury is backstopping losses, but the taxpayer risks here are greater than what the Fed took on in 2008-2009.
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> The Fed may feel all of this is essential to protect the financial system's plumbing and reduce systemic risk until the virus crisis passes, but make no mistake that the Fed is protecting Wall Street first. The goal seems to be to lift asset prices, as the Fed did after the financial panic, and hope that the wealth effect filters down to the rest of the economy.

The bank bailout of 2008 has been roundly cited as a case of the government putting Wall Street ahead of Main Street, and it contributed significantly to the populism that has riven American politics ever since. This recent step to rescue leveraged lenders may add further fuel to that fire.

* * *

The market seems to have passed judgment with regard to the future. U.S. deaths have reached 23,000 and continue to rise. Weekly unemployment claims are running at 10 times the all-time record. The GDP decline in the current quarter is likely to be the worst in history. But people are cheered by the outlook for therapies and vaccines, and investors have concluded that the Fed/Treasury will reduce the pain and bring on a V-shaped recovery. There's an old saying that "you can't fight the Fed" – that is, the Fed can accomplish whatever it wants – and investors are buying it. Thus, the S&P 500 has risen 23% since its bottom on March 23, and there's little concern about the retrenchments that typically have been part of past market rallies.

But Justin Beal, my artist son-in-law, is mystified. "I don't get it," he told me on Saturday. "The virus is rampant, business is frozen, and the government's throwing money all over the place, even though tax revenues have to be down. How can the market be rising so strongly?" We'll find out as the future unfolds.

April 14, 2020

Legal Information and Disclosures

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From: Howard Marks

Re: Uncertainty

I wrote a memo a week for six weeks starting on March 3, but I've skipped the last three weeks. First, the string had to end sometime. And second, I try to adhere to the principle that if I don't have anything additive to say, I don't write. Hopefully you'll find this one worth reading.

Our inability to know the future is a theme I've touched on repeatedly over the years, but now I've decided to devote an entire memo to it. Being at home for nearly two months means I've had a lot of time on my hands, like everyone else. And it's a good thing, because getting philosophical musings down on paper is a lot harder than writing about current events and what to do about them.

And while I'm explaining myself, I'll apologize up front for the number of citations and their length – but there's so much wisdom I want to share.

All We Don't Know

As everyone knows, today we're experiencing unprecedented (or at least highly exceptional) developments in four areas: the pandemic, the economic contraction, the oil price collapse and the Fed/government response. Thus a number of considerations make the future particularly unpredictable these days:

- The field of economics is muddled and imprecise, and there's good reason it's called "the dismal science." Unlike a "real" science like physics, in economics there are no rules that one can count on to consistently produce a given outcome, as in "if a, then b." There are only patterns that tend to repeat, and while they may be historical, logical and often-observed, they're still only tendencies.
- In some recent memos, I've mentioned Marc Lipsitch, Professor of Epidemiology at Harvard's T.H. Chan School of Public Health. In my version of his hierarchy, there are (a) facts, (b) logical inferences from past experience and (c) guesses. Because of the imprecision of economics, there certainly are no facts about the economic future. Economists and investors make inferences from past patterns, but these are unreliable at best, and I think in many cases their judgments fall under the heading of "guesses."
- These days I'm often asked questions like "Will the recovery be V-shaped, or a U, W or L?" and "Which of the crises you've lived through does this one most resemble?" Answering questions like those requires a historical perspective.
- Given the exceptional developments enumerated above, however, there's little or no history that's relevant to today. That means we don't have past patterns to fall back on or to extrapolate from. **As I've said, if you've never experienced something before, you can't say you know how it's going to turn out.**
- While unique developments like those of today make forecasting unusually difficult, the presence of all four elements at once probably renders it impossible. In addition to the

difficulty of understanding each of the four individually, we can't be sure how they'll interact. For example:

- Will the massive, multi-faceted Fed/Treasury program of loans, grants, stimulus and bond buying be sufficient to offset the unparalleled damage done to the economy by the fight against Covid-19?
- To what extent will reopening bring back economic activity, and to what extent will that cause the spread of the disease to resume, and the renewal of lock-downs?

For investors, the future is determined by thousands of factors, such as the internal workings of economies, the participants' psyches, exogenous events, governmental action, weather and other forms of randomness. Thus the problem is enormously multi-variate. Take the current situation, with its four major components (Covid-19, the economy, oil and the Fed), and consider just one: the disease. Now think about all the questions surrounding it:

- How many people have it, including those who are asymptomatic?
- How likely is contact with someone who's infected to create another case?
- To what degree will distancing and masks deter its spread?
- Will the cases be severe, mild or asymptomatic? Why?
- Will the supply of protective gear for medical personnel, hospital beds and ventilators be adequate?
- Will a treatment be developed? To what extent will it speed recovery and prevent fatalities?
- What will the fatality rate be relative to age, gender and pre-existing conditions? Will the impact of the disease on young people worsen?
- Will people who've had it and recovered be immune? Will their immunity be permanent?
- Will the virus mutate, and will immunity cover the new forms?
- Will it be possible to inject antibodies to prevent infection?
- How many people have to be immune for herd immunity to effectively stop the further spread?
- Will social distancing delay the achievement of herd immunity? Is the Swedish approach better?
- Will a vaccine be invented? When? How long will it take to produce and deliver the needed doses? Where will the U.S. stand in the line to get it?
- How many people will refuse to be vaccinated? With what effect?
- Will vaccination have to be renewed annually?
- Will the virus succumb to warm weather and humidity?
- Will the virus be with us permanently, and will it be controllable like "just another seasonal disease"?

Where am I going with this? My point is that very few people can balance all these considerations to figure out our collective risk. And that's just Covid-19. Now think about the many questions that pertain to each of the three other factors. **Who can respond to this many questions, come up with valid answers, consider their interaction, appropriately weight the various considerations on the basis of their importance, and process them for a useful conclusion regarding the virus's impact?** It would take an exceptional mind to deal with all these factors simultaneously and reach a better conclusion than most other people. (I believe a computer couldn't do so either, especially given all the subjective decisions required in the absence of historic precedent.)

The challenge lies in trying to be **above average** in assessing the future. Why is that so hard?

First of all, forecasting is a competitive arena. **The argument for the difficulty of out-forecasting others is similar to the argument for market efficiency (and thus the limitations of active management).** Thousands of others are trying, too, and they're not "empty suits." Many of them are educated, intelligent, numerate, hard-working, highly motivated and able to access vast amounts of data and computing power. So by definition it shouldn't be easy to be better than the average.

In addition, since economics is imprecise, unscientific and inconsistent in its functioning, as described above, there can't be a method or process for forecasting that works consistently. To illustrate randomness, I say that if, when I graduated from business school, I was offered a huge budget, an army of PhDs and lavish financial incentives to predict the coin toss before each Sunday's football games, I would have been a flop. **No one can succeed in predicting things that are heavily influenced by randomness and otherwise inconsistent.**

Now consider the possibility that reaching conclusions is especially difficult in times of stress like today:

> [Recent advances in neuroscience] suggest that we are no more than "inference machines" with various degrees of sophistication in how we explain our thoughts. In other words, we use a lot of pattern-driven guesswork as we go about our daily lives or to fill in the gaps in an incomplete narrative.
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> This is especially true in times of stress, as many of the mental processes that govern our reactions are associated with an urgent search for patterns to determine our moves. **That is our snap reaction in economic or financial crises and why we cling to our repertoire of charts of V, U or L-shapes of recovery, among many.**
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> But, in very dislocated environments, we find serious limitations to this approach.
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> Looking at the current environment, with disruptions to supply, demand, health and liquidity tensions, we could build an ensemble of the Spanish flu, the Fukushima earthquake and components of the 2008 crisis, for example. But given the very specific contexts of each event, we may run into endless combinations of the lessons learnt from these events.
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> **As a matter of fact, in a side-by-side comparison of many economic forecasts, even similar assumptions drive very different outcomes on how this crisis will play out.** This may be a case of the "Anna Karenina principle" coined by Professor Yossi Sheffi at Massachusetts Institute of Technology. Paraphrasing Tolstoy, while happy economies are all alike, every unhappy economy is unhappy in its own way.
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> We can't assume that the response to public health or financial interventions will be similar across vastly different contexts. **The root cause of this mistake is to look at average responses from past events. But the reality is not like that.** (Juan-Luis Perez, head of research, Evidence Lab and Analytics, at UBS, the *Financial Times,* April 22, emphasis added)

So forecasting is difficult for a large number of reasons, including our limited understanding of the processes that will produce the future, their imprecise nature, the lack of historical precedent, the unpredictability of people's behavior and the role of randomness, and these difficulties are exacerbated by today's unusual circumstances.

Senior economics consultant Neil Irwin put it together very well in *The New York Times* on April 16:

> The world economy is an infinitely complicated web of interconnections. We each have a series of direct economic interrelationships we can see: the stores we buy from, the employer that pays our salary, the bank that gives us a home loan. But once you get two or three levels out, it's really impossible to know with any confidence how those connections work.
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> And that, in turn, shows what is unnerving about the economic calamity accompanying the spread of the novel coronavirus.
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> In the years ahead we will learn what happens when that web is torn apart, when millions of those links are destroyed all at once. And it opens the possibility of a global economy completely different from the one that has prevailed in recent decades.

I couldn't agree more with what Irwin says. Or, to use one of my all-time favorite quotes, from John Kenneth Galbraith:

> We have two classes of forecasters: Those who don't know – and those who don't know they don't know.

While I'm in the subject of favorite quotes, I'll take advantage of the occasion to share some others on this subject that I've stored up over the years (I think the first one may be the greatest ever):

> **No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future.**
>
> Ian Wilson (former GE executive)

> Those who have knowledge don't predict; those who predict don't have knowledge.
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> Lao Tzu

> People can foresee the future only when it coincides with their own wishes, and the most grossly obvious facts can be ignored when they are unwelcome.
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> George Orwell

Forecasts create the mirage that the future is knowable.

Peter Bernstein

I never think of the future – it comes soon enough.

Albert Einstein

The future you shall know when it has come; before then forget it.

Aeschylus

Forecasts usually tell us more of the forecaster than of the future.

Warren Buffett

I think you get the point. I seem to be in good company in my belief that the future is unknowable.

Having made that assertion, I'll admit that it's an extreme oversimplification and not entirely correct. There actually are things we know about the macro future. The trouble is that, mostly, they're things everyone knows. Examples include the fact that U.S. GDP grows about 2% per year on average; heating oil consumption increases in winter; and a great deal of shopping is moving on-line. But since everyone knows these things, they're unlikely to be much help in the pursuit of above average returns. As I've described before, the things most people expect to happen – consensus forecasts – are by definition incorporated into asset prices at any point in time. Since the future is usually a lot like the past, most forecasts – and especially macro forecasts – are extrapolations of recent trends and current levels, and they're built into prices. Since extrapolation is appropriate most of the time, most people's forecasts are roughly correct. But because they're already reflected in security prices, **most extrapolations aren't a source of above average returns**.

The forecasts that produce great profits are the ones that presciently foresee radical deviations from the past. But that kind of forecast is, first, very hard to make and, second, rarely right. **Thus most forecasts of deviation from trend <u>also</u> aren't a source of above average returns.**

So let me recap: (a) only correct forecasts of a very different future are valuable, (b) it's hard to make forecasts like that, (c) such unconventional predictions are rarely right, (d) thus it's hard to be an above average forecaster, and (e) it's only above average forecasts that lead to above average returns.

So there's a conundrum:

- Investing is the art of positioning capital so as to profit from future developments.
- Most professional investors strive for above average returns (i.e., they want to beat the market and earn their fees).

- However, according to the above logic, macro forecasts shouldn't be expected to lead to above average returns.
- Yet very few people are content to invest while practicing agnosticism with regard to the macro future. They may on some level understand the difficulty entailed in forecasting, but their reluctance to admit their ignorance of the future (especially to themselves) usually overcomes that understanding with ease.
- And so they keep trying to predict future events – and the investment industry produces a large volume of forecasts.

As I've expressed in recent memos, I feel the process through which most of us arrive at our view of the future is highly reflective of our biases. Given the unusually wide chasm between the optimistic and pessimistic cases at this time – and the impossibility of choosing between them based on facts and historical precedents (since there are none) – I continue to think about the role of bias.

One of the biggest mistakes an investor can make is ignoring or denying his or her biases. If there are influences that make our processes less than objective, we should face up to this fact in order to avoid being held captive by them.

Our biases may be insidious, but they are highly influential. When I read articles about how difficult it will be to provide adequate testing for Covid-19 or to get support to small businesses, I'm pleased to see my wary views reinforced, and I find it easy to incorporate those things into my thinking. But when I hear about the benefits of reopening the economy or the possibility of herd immunity, I find it just as easy to come up with counter-arguments that leave my concerns undented. This is a clear example of "confirmation bias" at work:

> Once we have formed a view, we embrace information that confirms that view while ignoring, or rejecting, information that casts doubt on it. Confirmation bias suggests that we don't perceive circumstances objectively. We pick out those bits of data that make us feel good because they confirm our prejudices. Thus, we may become prisoners of our assumptions. (Shahram Heshmat, *Psychology Today*, April 23, 2015)

As Paul Simon wrote 50 years ago for the song *The Boxer*, ". . . a man hears what he wants to hear and disregards the rest."

While I didn't know the name for it, I've long been aware of my bias. In a recent memo, I told the story from 50 years ago, when I was Citibank's office equipment analyst, of being asked who the best sell-side analyst on Xerox was. My answer was simple: "The one who agrees with me most is so-and-so." Most people are unlikely to think highly of anyone whose views they oppose. So when we think about which economists we quote, which investors we respect, and where we get our information, it's likely that their views will parallel ours.

Of course, taken to an extreme, this has resulted in the unfortunate, polarized state in which we find the U.S. today. News organizations realized decades ago that people would rather consume stories that confirm their views than those that challenge them (or are dully neutral). Few people follow media outlets that reflect a diversity of opinion. Most people stick to one newspaper, cable news channel or political website. And few of those fairly present both sides of the story. Thus most people hear a version of the news that is totally unlike the one heard by those on the other side of the debate. When all the facts and opinions you hear confirm your own beliefs, mental life is very relaxed but not very enriching.

What's the ideal? A calm, open mind and an objective process. Wouldn't we all be better off if those things were universal?

In Praise of Doubt

Another favorite theme of mine – and I'm mildly apologetic for its repetition in these memos – is how important it is to acknowledge what we don't know.

First of all, if we're going to out-invest the rest, we need a game plan. There are a lot of possible routes to success on which to base your process: in-depth research into companies, industries and securities; arbitrage; algorithmic investing; factor investing; even indexation. But if I'm right about the difficulty of macro forecasting, for most people that shouldn't be it.

Second, and probably more importantly, excessive trust in forecasting can be dangerous to your financial health. It's never been put better than in the quote that's often attributed to Mark Twain, but also to several others:

> **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.**

Just a few words, but a great deal of wisdom. No statement that starts with "I don't know but . . ." or "I could be wrong but . . ." ever got anyone into big trouble. If we admit to uncertainty, we'll investigate before we invest, double-check our conclusions and proceed with caution. We may sub-optimize when times are good, but we're unlikely to flame out or melt down. **On the other hand, people who are sure may dispense with those things, and if they're sure and wrong, as the quote suggests, the outcome can be catastrophic.**

Investing is challenging in this way, as in so many others. **Active investors have to be confident.** Yale's David Swensen said it as well as it can be said (that's why I go back to this quote so often in my memos and books):

> Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom. (*Pioneering Portfolio Management*)

To do better than most, you have to depart from the crowd. As I said in my April 6 memo *Calibrating*, echoing Swensen, all great investments begin in discomfort, since the things everyone likes and feels good about are unlikely to be on the bargain counter. But to invest in things that are out of favor – at the risk of standing out from the crowd and appearing to have made a big mistake – takes confidence and resolve. It also requires confidence to hold onto a position when it declines – and perhaps add to it at lower prices – in the period before one's wisdom becomes clear and it turns into a winner. And it takes confidence to continue holding a highly appreciated investment you think still has upside potential, at the risk of possibly giving up some of the gains to date.

But when does reason-based confidence turn into hubris and obstinateness? That's the key question. Holding and adding to declining positions is only a good idea if the underlying thesis turns out to be right and things eventually go as expected. In other words, when do you allow for the possibility that you're wrong?

From the very beginning of my investing career, I've felt a sense of uncertainty. But I don't think that's a bad thing:

- "Investing scared" – a less glamorous term than "applying appropriate risk aversion" – will push you to do thorough due diligence, employ conservative assumptions, insist on an ample margin of safety in case things go wrong, and invest only when the potential return is at least commensurate with the risk. **In fact, I think worry sharpens your focus.** Investing scared will result in making fewer mistakes (although perhaps at the price of failing to take maximum advantage of bull markets).
- When I started investing in high yield bonds in 1978, and when Bruce Karsh and I first targeted distressed debt in 1988, it seemed clear that the route to long-term success in such uncertain areas lay in limiting losses rather than targeting maximum gains. That approach has permitted us to still be here, while many one-time competitors no longer are.
- I can tell you that in the Global Financial Crisis, following the bankruptcy of Lehman Brothers, we felt enormous uncertainty. If you didn't, there was something wrong with you, since there was a meaningful possibility the financial system would collapse. When we started buying, Bruce came to me often saying, "I think we're going too slow," and then the next day, "I think we're going too fast." But that didn't keep him from investing an average of $450 million per week over the last 15 weeks of 2008. **I think Bruce's ability to grapple with his doubts helped him arrive at the right pace of investment.**

The topic of dealing with what you don't know brings me to a phrase I came across a few years ago and think is very important: intellectual humility.

Here's part of the article that first brought it to my attention:

> "Intellectual humility" has been something of a wallflower among personality traits, receiving far less scholarly attention than such brash qualities as egotism or hostility. Yet this little-studied characteristic may influence people's decision-making abilities in politics, health and other arenas, says new research from Duke University. . . .
>
> As defined by the authors, **intellectual humility is the opposite of intellectual arrogance or conceit. In common parlance, it resembles open-mindedness. Intellectually humble people can have strong beliefs, but recognize their fallibility and are willing to be proven wrong on matters large and small**, Leary said. (Alison Jones, *Duke Today*, March 17, 2017, emphasis added)

To get a little more technical, here are a couple of useful paragraphs from a discussion of the paper cited above:

> The term, intellectual humility (IH), has been defined in several ways, but most definitions converge on the notion that IH involves recognizing that one's beliefs and

> opinions might be incorrect. . . . Some definitions of IH include other features or characteristics – such as low defensiveness, appreciating other people's intellectual strengths, or a prosocial orientation . . .
>
> **One conceptualization defines intellectual humility as recognizing that a particular personal belief may be fallible, accompanied by an appropriate attentiveness to limitations in the evidentiary basis of that belief and to one's own limitations in obtaining and evaluating relevant information**. This definition qualifies the core characteristic (recognizing that one's belief may be wrong) with considerations that distinguish IH from mere lack of confidence in one's knowledge or understanding. IH can be distinguished from uncertainty or low self-confidence by the degree to which people hold their beliefs tentatively specifically because they are aware that the evidence on which those beliefs are based could be limited or flawed, that they might lack relevant information, or that they may not have the expertise or ability to understand and evaluate the evidence. (*The Psychology of Intellectual Humility*, Mark Leary, Duke University, emphasis added)

"Attentiveness to limitations in the evidentiary basis" (or to the limitations imposed by future uncertainty) is a very important further concept. Here's how I discussed it in my book *Mastering the Market Cycle*:

> Most people think the way to deal with the future is by formulating an opinion as to what's going to happen, perhaps via a probability distribution. I think there are actually two requirements, not one. In addition to an opinion regarding what's going to happen, people should have a view on the likelihood that their opinion will prove correct. Some events can be predicted with substantial confidence (e.g., will a given investment grade bond pay the interest it promises?), some are uncertain (will Amazon still be the leader in online retailing in ten years?) and some are entirely unpredictable (will the stock market go up or down next month?) It's my point here that not all predictions should be treated as equally likely to be correct, and thus they shouldn't be relied on equally. I don't think most people are as aware of this as they should be.

In short, we have to have a realistic view of the probability that we're right before we choose a course of action and decide how heavily to bet on it. And anyone who's sure about what's going to happen in the world, the economy or the markets is probably deceiving himself.

It all comes down to dealing with uncertainty. To me, that starts with acknowledging uncertainty and having an appropriate degree of respect for it. As I quoted Annie Duke this past January, in my memo [You Bet!]:

> What good poker players and good decision-makers have in common is their comfort with the world being an uncertain and unpredictable place. They understand that they can almost never know exactly how something will turn out. They embrace that uncertainty and, instead of focusing on being sure, they try to figure out how *unsure* they are, making their best guess at the chances that different outcomes will occur. (*Thinking in Bets*)

To put it simply, intellectual humility means saying "I'm not sure," "The other person could be right," or even "I might be wrong." I think it's an essential trait for investors; I know it is in the people I like to associate with.

As so often happens when I'm thinking about a memo, I recently got an incredibly helpful note from my friend Leslie Lichtenstein at the University of Chicago, connecting the concept of humility to the current episode. Here's what she wrote:

> This morning I read an article from *Behavioral Scientist* by Erik Angner [professor of practical philosophy at Stockholm University] called "Epistemic Humility – Knowing Your Limits in a Pandemic," which made me think of you and several of your recent memos. The article opens with a quote from Charles Darwin in 1871 – "**Ignorance more frequently begets confidence than does knowledge." It goes on to say, "Being a true expert involves not only knowing stuff about the world but also knowing the limits of your knowledge and expertise**." (Emphasis in Leslie's note)

I couldn't agree more. People who are always sure are no more helpful than people who are never sure. The real expert's confidence is reason-based and proportional to the weight of the evidence. Leslie's note sent me to the original of the article she cited, and I found so much to share:

> In the middle of a pandemic, knowledge is in short supply. We don't know how many people are infected, or how many people will be. We have much to learn about how to treat the people who are sick – and how to help prevent infection in those who aren't. There's reasonable disagreement on the best policies to pursue, whether about health care, economics, or supply distribution. Although scientists worldwide are working hard and in concert to address these questions, final answers are some ways away.
>
> Another thing that's in short supply is the realization of how little we know. . . .
>
> Frequent expressions of supreme confidence might seem odd in light of our obvious and inevitable ignorance about a new threat. The thing about overconfidence, though, is that it afflicts most of us much of the time. That's according to cognitive psychologists, who've studied the phenomenon systematically for half a century. Overconfidence has been called "the mother of all psychological biases. . . ."
>
> The point is not that true experts should withhold their beliefs or that they should never speak with conviction. Some beliefs are better supported by the evidence than others, after all, and we should not hesitate to say so. The point is that true experts express themselves with the proper degree of confidence – meaning with a degree of confidence that's justified given the evidence. . . .
>
> [Compare what you hear on TV against a tweet from medical statistician Robert Grant]: "I've studied this stuff at university, done data analysis for decades, written several NHS guidelines (including one for an infectious disease), and taught it to health professionals. **That's why you don't see me making any coronavirus forecasts. . . .**"

> The concept of epistemic humility is . . . an intellectual virtue. It is grounded in the realization that our knowledge is always provisional and incomplete – and that it might require revision in light of new evidence. Grant appreciates the extent of our ignorance under these difficult conditions; the other characters don't. A lack of epistemic humility is a vice – and it can cause massive damage both in our private lives and in public policy.
>
> Calibrating your confidence can be tricky. As Justin Kruger and David Dunning have emphasized, our cognitive and metacognitive skills are intertwined. People who lack the cognitive skills required to perform a task typically also lack the metacognitive skills required to assess their performance. **Incompetent people are at a double disadvantage, since they are not only incompetent but also likely unaware of it [Galbraith's forecasters "who don't know they don't know"!].** This has immediate implications for amateur epidemiologists. If you don't have the skill set required to do advanced epidemiological modeling yourself, you should assume that you can't tell good models from bad.
>
> . . . it's never been more important to learn to separate the wheat from the chaff – the experts who offer well-sourced information from the charlatans who offer little but misdirection. The latter are sadly common, in part because they are in greater demand on TV and in politics. It can be hard to tell who's who. But paying attention to their confidence offers a clue. People who express themselves with extreme confidence without having access to relevant information *and* the experience and training required to process it can safely be classified among the charlatans until further notice. . . .
>
> Again, it is fine and good to have opinions, and to express them in public – even with great conviction. **The point is that true experts, unlike charlatans, express themselves in a way that mirrors their limitations.** All of us who want to be taken seriously would do well to demonstrate the virtue of epistemic humility. (Erik Angner, *Behavioral Scientist*, April 13, emphasis added)

The more I think about it, the bottom line is clear:

- The world is an uncertain place.
- It's more uncertain today than at any other time in our lifetimes.
- Few people know what the future holds much better than others.
- **And yet investing deals entirely with the future, meaning investors can't avoid making decisions about it.**
- Confidence is indispensable in investing, but too much of it can be lethal.
- The bigger the topic (world, economy, markets, currencies and rates), the less possible it is to achieve superior knowledge.
- **Even our decisions about smaller things (companies, industries and securities) have to be conditioned on assumptions regarding the bigger things, so they, too, are uncertain.**
- The ability to deal intelligently with uncertainty is one of the most important skills.

- In doing so, we should understand the limitations on our foresight and whether a given forecast is more or less dependable than most.
- Anyone who fails to do so is probably riding for a fall.

As Neil Irwin wrote in the article cited on page 4:

> It would be foolish, amid such uncertainty, to make overly confident predictions about how the world economic order will look in five years, or even five months.

Or maybe Voltaire said it best 250 years ago: **Doubt is not a pleasant condition, but certainty is absurd.**

May 11, 2020

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Memo to: Oaktree Clients

From: Howard Marks

Re: Uncertainty II

I've written a few times about the frequency with which I come across something additive just before finalizing a memo. This time I wasn't so lucky: my wife Nancy brought an important article to my attention two weeks after the publication of *Uncertainty*. The article's appearance, along with a second potential addition, prompts me to write this post-script to that memo. I have a few thoughts to add, all generally related to the topic of foreknowledge.

No One Knows What's Going to Happen

The above heading was the title of an excellent article by Mark Lilla, a professor of humanities at Columbia University, which appeared in *The New York Times* this past Sunday. (You may remember my previous discussion of our tendency to think highly of people who agree with us. I readily admit that the reason I like this article so much may lie in the fact that it confirms a great deal of what I said in *Uncertainty*.) Here are some excerpts from that article:

> **The best prophet, Thomas Hobbes once wrote, is the best guesser.** That would seem to be the last word on our capacity to predict the future: We can't.
>
> **But it is a truth humans have never been able to accept.** People facing immediate danger want to hear an authoritative voice they can draw assurance from; they want to be told what will occur, how they should prepare, and that all will be well. We are not well designed, it seems, to live in uncertainty. **Rousseau exaggerated only slightly when he said that when things are truly important, we prefer to be wrong than to believe nothing at all**. . . .
>
> **Apart from the actual biology of the coronavirus – which we are only beginning to understand – nothing is predestined. How many people fall ill with it depends on how they behave, how we test them, how we treat them and how lucky we are in developing a vaccine.**
>
> The result of those decisions will then limit the choices about reopening that employers, mayors, university presidents and sports club owners are facing. Their decisions will then feed back into our own decisions, including whom we choose for president this November. And the results of that election will have the largest impact on what the next four years will hold.
>
> The pandemic has brought home just how great a responsibility we bear toward the future, and also how inadequate our knowledge is for making wise decisions and anticipating consequences. Perhaps that is why our prophets and augurs can't keep up with the demand for foresight.

> At some level, people must be thinking that the more they learn about what is predetermined, the more control they will have. This is an illusion. **Human beings want to feel that they are on a power walk into the future, when in fact we are always just tapping our canes on the pavement in the fog.**
>
> A dose of humility would do us good in the present moment. It might also help reconcile us to the radical uncertainty in which we are always living. Let us retire our prophets and augurs. [Emphasis added]

Lilla's article pulls together in one place several themes from *Uncertainty* and other recent memos:

- the very human hunger for forecasts to help us navigate the future,
- the conditionality of the future on multiple future developments,
- our own ability to influence the future through the decisions we make,
- the unpredictability of each development,
- thus the futility of forecasting,
- the importance of accepting our ignorance of the future, and thus
- the general importance of intellectual humility.

Articles like this one and those cited in my last memo should drive home these points to everyone's satisfaction. **But rarely will people fully accept that we must make decisions regarding the future without knowing it.**

<u>The Future as Path-Dependent</u>

Forecasters seem to act as if the future already exists, and all we have to do is be smart enough to discern it. **But that ignores the fact that all of us – and many other influences – are constantly creating the future through our collective activity.**

In his article, Lilla stated, ". . . the post-Covid future doesn't exist. It will exist only after we have made it." I think this is a very important concept. We might predict the future today, and we might even correctly assess what today's conditions and actions are likely to produce in the future. But that prediction will be shown to have been right only if no one and nothing causes the future to become different between now and the day it arrives. Thus I'll repeat what I quoted from Lilla earlier:

> How many people fall ill with [the coronavirus] depends on how they behave, how we test them, how we treat them and how lucky we are in developing a vaccine.

Not only how will the virus behave, morph, travel, react to warm weather and infect, but also how fast will we reopen the economy, how will people behave when we reopen it, and what will the virus do at that time? Thomas Sowell, a Hoover Institution economist and social theorist, provided a glimpse at how these things work in another field:

> Economists are often asked to predict what the economy is going to do. But economic predictions require predicting what politicians are going to do – and nothing is more unpredictable.

The unpredictability of politicians is only one of the many variables complicating the future today. Not only can't we predict people's actions and the many other things that will determine the course of the virus and its impact on the economy, but we also certainly can't predict when they'll take those actions – and that will count just as much.

Which Expert to Follow?

In the memo *Uncertainty*, I quoted at considerable length from an article by Erik Angner. One of its most interesting points was as follows:

> People who lack the cognitive skills required to perform a task typically also lack the metacognitive skills required to assess their performance. Incompetent people are at a double disadvantage, since they are not only incompetent but also likely unaware of it. (*Behavioral Scientist*, April 13)

By definition, people who lack the expertise in a given field required for superior judgments also lack the expertise required to assess their level of expertise. As I mentioned, they qualify as John Kenneth Galbraith's forecasters "who don't know they don't know."

While re-reading my memo, I realized I had left out an important further ramification. Not only do most people fail to possess superior expertise – as well as the ability to know it – but they also lack the ability to figure out who does have it. **That's the catch: you may have to be an expert in a field in order to be able to figure out who the true experts are.** That's why research in most fields is subjected to "peer review," meaning a review by experts (not to be confused with "a jury of one's peers," meaning other lay citizens).

And yet, where does the buck stop on the biggest of questions, like those of today? The answer can't be "with the experts." An article in *The Wall Street Journal* set out the dilemma:

> To govern, at least at the level of the presidency, is to make hard choices among competing options with incomplete information. Easier problems are resolved before they ever reach the Oval Office. Neither scientific data nor public sentiments can properly answer the questions that face elected officials. Both are important and must be integrated into the judgments that political leaders make. But neither can substitute for that crucial act of judgment. . . .
>
> The president's job, and not only in times of crisis, frequently involves listening to experts disagree with one another and taking responsibility for choosing among them, plotting a course through opportunities and dangers. **The capacity to do this well involves its own sort of practical wisdom, an expertise in judging expertise**. . . . ("Experts Aren't Enough," May 16-17, emphasis added)

Nowadays, like everyone else, I'm bombarded with conflicting views regarding the wisdom of rapidly reopening the U.S. economy. **Yet I recognize that not only is my opinion on that topic of little value, but I also don't have the expertise required to know for sure whose opinion does count.** What I do know is that the last thing I should do is choose an expert because his or her opinions agree with mine, and allow confirmation bias to affect my decision.

Further, in considering expertise, we must be leery of some dangerous tendencies in our society:

- to confuse general intelligence with knowledge of the facts relative to a given field,
- to confuse factual knowledge with superior insight,
- to conflate expertise and insight with the ability to predict the future,
- to treat experts in one field as if they're knowledgeable about all others, and
- to credit rich and successful people with all of the above.

Thus, as I've described in previous memos, when I travel abroad, I'm often asked what I think of my host countries' economies and their potential. "Why ask me?" I respond, "you live here." Just because I know something about investing and the U.S., why should I necessarily have meaningful insight into other fields and countries?

We see doctors or public health officials on TV who inveigh against quickly reopening the economy. They may well know much more than most about the medical and public health aspects of the coronavirus and how it should be dealt with, and their advice is likely to keep the most people alive. But on the other hand, since they're not economists, we should assume they're only answering from the standpoint of minimizing deaths. They may not take into consideration the importance of restarting the economy or how to balance the two considerations.

On the other hand, we see businesspeople and economists talking about the need to reopen in order to minimize the damage done to the economy by keeping it in a deep freeze. But what do they know about the cost in human lives? And certainly there is no algorithm or accepted process for deciding between the two. It's a matter of judgment, not expertise.

I recently read an article about an often-cited libertarian lawyer and legal scholar (unnamed here because of my general practice of not criticizing individuals) who predicted in mid-March that no more than 500 people would die from Covid-19 in the U.S. (revised upward to 5,000 when he later found a statistical error in his analysis). While he admitted to having no medical expertise, he said he did know more than the doctors about evolutionary theory and its applicability to the virus. His opinion apparently carried great weight at the time in conservative quarters.

Reporters, not being experts themselves, have to consult experts in order to write their stories. But how do they choose and vet the experts they cite? And to what extent are their selections a function of the biases we all tend to confirm and the conclusions they want to justify? In my experience, the more I know about a subject, the less I'm impressed with related media coverage.

And likewise, elected officials are rarely expert in the fields about which they have to make decisions. They, too, have no choice but to depend on experts. But how do they choose their experts? Would they ever consult an expert who belongs to the other party? I recently read a *Wall*

Street Journal op-ed piece by a conservative senator suggesting categorically that conservatives and liberals are different in how they weigh re-opening the economy versus minimizing infections. Is such a sweeping (and probably unscientific) generalization more likely to be an appropriate observation or an example of intellectual bias stemming from ideological division?

So (a) true expertise is scarce and limited in scope, (b) expertise and predictive ability are two different things, and (c) we all should be careful about whom we listen to and how much weight we give to their pronouncements.

And one other thing: As Lilla wrote, "People facing immediate danger want to hear an authoritative voice . . ." Thus they tend to put inordinate faith in a popular "prophet." And when he or she turns out to be a less-than-perfect forecaster, and thus only human, they go looking for the next one to anoint. **They never say, "I guess forecasting doesn't work."** I would say the same about people in general, including those looking for help making money without risk or effort.

A Living Example

Finally, in a related vein, I want to mention a May 19 article by Morgan Housel of Collaborative Fund, an insightful commentator whose philosophical and behavioral observations tend to resonate with me. In it, he told the story of two friends with whom he regularly took the risk of skiing out of bounds at the resort they frequented as teens. One day, his friends went out for a second run while he begged off for no particular reason, and a freak avalanche took their lives. Here's his summation:

> I don't know if Brendan and Bryan's death actually affected how I invest. But it opened my eyes to the idea that there are three distinct sides of risk:
>
> - **The odds you will get hit.**
> - **The average consequences of getting hit.**
> - **The tail-end consequences of getting hit.**
>
> The first two are easy to grasp. It's the third that's hardest to learn, and can often only be learned through experience.
>
> We knew we were taking risks when we skied. We knew that going out of bounds was wrong, and that we might get caught. But at 17 years old we figured the consequences of risk meant our coaches might yell at us. Maybe we'd get our season pass revoked for the year.
>
> Never, not once, did we think we'd pay the ultimate price.
>
> But once you go through something like that, you realize that the tail-end consequences – the low-probability, high-impact events – are all that matter. In investing, the average consequences of risk make up most of the daily news headlines. But the tail-end consequences of risk – like pandemics, and depressions – are what make the pages of history books. *They're all that matter*. They're all you should focus on. We spent the last decade debating whether economic risk meant the

> Federal Reserve set interest rates at 0.25% or 0.5%. Then 36 million people lost their jobs in two months because of a virus. It's absurd.
>
> Tail-end events are all that matter.

This introduces one of the great conundrums associated with investing. Since we know nothing about the future, we have no choice but to rely on extrapolation of past patterns. By "past patterns," we mean what has normally happened in the past **and with what severity**. And yet, there's no reason why (a) things can't happen that differ from those that happened in the past and (b) future events can't be worse than those of the past in terms of severity and thus consequences. While we look to the past for guidance as to the "worst case," there's no reason why future experience should be limited to that of the past. But without reliance on the past to inform us regarding the worst case, we can't know much about how to invest our capital or live our lives.

Many years ago, my friend Ric Kayne pointed out that **"95% of all financial history happens within two standard deviations of normal, and everything interesting happens outside of two standard deviations."** Arguably, bubbles and crashes fall outside of two standard deviations, but they are the events that create and eliminate the greatest fortunes. We can't know much in advance about their nature or dimensions. Or about rare, exogenous events like pandemics.

In 2001, I wrote a memo titled *You Can't Predict. You Can Prepare.* At first glance, that seems like an oxymoron. How can we prepare for something if we can't predict it? Turned around, if the greatest extremes and most influential exogenous events are unpredictable, how can we prepare for them? We can do so by recognizing that they inevitably will occur, and by making our portfolios more cautious when economic developments and investor behavior render markets more vulnerable to damage from untoward events.

That line of reasoning suggests a glimmer of good news: we may not be able to predict the future, but that doesn't mean we're powerless to deal with it.

May 28, 2020

Legal Information and Disclosures

Memo to: Oaktree Clients

From: Howard Marks

Re: Not Enough

> Whatever affects one directly, affects all indirectly. I can never be what I ought to be until you are what you ought to be. This is the interrelated structure of reality. (Rev. Dr. Martin Luther King, Jr., 1965)

> Justice will not be served until those who are unaffected are as outraged as those who are. (Benjamin Franklin, 1750)

In recent weeks we have witnessed the killing of George Floyd by a Minneapolis policeman who knelt on his neck for almost nine minutes while three others stood by doing nothing, and we have watched peaceful protests and violent riots take place in cities across America and around the world.

We understand the death of George Floyd as one more of the glaring injustices suffered by black people and other people of color in our country. It adds to a long list of injustices ranging from profiling, harassment, brutality and killing at the hands of police; to disproportionate rates of addiction, prosecution, incarceration and sentencing; to highly unequal access to education, jobs, pay, health care, safe neighborhoods, decent housing and financial security; to having to live everyday with demoralizing indignities and fear for one's children's lives; and lately to above average rates of infection and fatality due to Covid-19.

Many Americans are speaking out in recognition of the grievances of black people. Leaders of society, government and business have made public statements designed to show their support. I want to add my voice to theirs and express my rejection of the status quo.

I've struggled to write this memo, and for that reason it's late in coming. I'm not a social commentator, and I have little to add that is unique, only my humanity. I certainly don't feel I know the solution or have the means to implement it. I'm afraid of coming across as holier-than-thou, and especially of saying something that anyone finds insensitive, patronizing or hurtful. I hold good thoughts in my heart and have always tried to be a good, thoughtful, inclusive person. **But I now know that's not enough.**

I find the statistics relating to the injustices listed above appalling, the result of individual as well as institutionalized racism going all the way back to the original sin of slavery. But behind the statistics – unpleasant as they are – are millions of individuals suffering. While the battle for civil rights was "won" a half-century ago, and we have talked about progress in the area of race, our society still denies equal opportunity to many.

The teenagers denied a quality education, who can't think of things to hope for or can't imagine achieving their dreams. The mothers who can't provide food and shelter for their families, and who have to look on with sadness, resentment or anger at a world full of things they're denied. The fathers who have to have "the talk" with their children, warning them to "yes, sir" the police, not move their hands too fast and not run down the street at night. The men who are stopped and asked why they're walking in upscale neighborhoods. The workers who don't have the luxury of ensuring safety by socially isolating, but have to go to work in proximity to others and then come home to close quarters and possibly infect their children or parents. The parents who have to send their children out into the world each day without confidence that they'll come back. These thoughts break my heart. **I feel deeply for every individual forced to live under these conditions. But I know I must do more than simply feel.**

I have talked in my memos of the fact that in the latter half of the 20th century, there was an economic "tide that lifted all boats." That tide may have enriched nations but not all people in those nations; instead, the benefits went to some but not others. Today the economic tide is no longer rising as strongly and the distribution is still more uneven; the advantages enjoyed by those with education or capital are being magnified; and the inequality of outcomes is simply no longer acceptable – hopefully to society and certainly to those getting less. It's a shame that it has taken so long for many of us to articulate that.

Our nation cannot endure for long if some people are denied basic human rights and opportunities simply because they belong to groups defined by color or race. This is true today and will become even truer as we move toward being a nation where the majority are members of minorities.

Millions of minority group members suffer as a result of the supposedly "human" tendency – which certainly is inhuman – to search for someone to look down on and thus impose a hierarchy based on race, skin color or ethnicity. Whether for reasons of history, economic insecurity, upbringing, the attractiveness of us-versus-them as an organizing principle, or their own bad luck or shortcomings, many people try to make themselves feel better by subjugating or abusing others, or at a very minimum they are indifferent to and unmoved by the suffering, deprivation and unequal lives of others. One of the lessons of recent weeks is that we must not tolerate the damage done by racists.

They say we should "walk a mile" in the shoes of others. And yet we can't. Fortunate folks like me can think about injustice and inequality as much as we like, but we can't live the constant sadness, fear or rage of those who are victimized by it. I and many others have come to understand those feelings more deeply because of the events surrounding the death of George Floyd. Now I believe the truth will finally be seen and something will be done about it – because it's the right thing to do and because of the growing realization that a civilization cannot long endure with people living lives of excessively different quality. **Each of us must commit to playing an active part in dismantling systemic racism and bringing about equality.**

The idea of racial justice goes hand-in-hand with the general concern over economic inequality that has increasingly motivated parts of the political spectrum in recent years. I've written about the need to grow the economic pie, but that's not enough. We must also repair how the pie is divided. Yes, the free market does a technically superior job of allocating resources. But we must no longer accept outcomes that are so unequal. Enrichment of a few and suffering for the rest is not a workable outcome for our society. We must address things like the poor quality of public education, the impediments to access to jobs and the limited progressivity of the tax system. The free market of economic theory must be adapted for modern life, and there are degrees of disparity that just cannot be accepted.

Oaktree's founders and senior management have worked to create a harmonious environment and one of shared opportunity and reward, where there is little hierarchy. We love and treasure all of our colleagues and want the best for them, and we revel in their success. But thoughts and words are not enough. We all have to redouble our efforts and come up with active solutions.

In 2017, Oaktree formalized what had been for many years an informal diversity and inclusion strategy intended to expand the population of women and underrepresented professionals at the firm. Since then our Diversity & Inclusion Council, in partnership with other employee groups, has launched a number of recruiting, development and training initiatives around equity, inclusion, mentorship and bias. But there is much more to do.

Next week we will convene a meeting led by our Underrepresented Groups Council as an opportunity to listen to our employees so as to be in position to implement programs in direct response to the events of these past weeks and ensure that Oaktree remains a place where all employees feel they can bring their whole selves to work. Under the banner of Our Communities Matter, Oaktree's program for community engagement and support, we will also launch a charitable giving program and special matching initiative to support front-line organizations nominated by our employees. And, moving forward, I will be devoting a significant amount of my personal energy and resources to combatting systemic racism.

It is imperative that all Americans see the recent events as a call for action and work to ensure equality for people of color. I pledge that Oaktree and I will heed this call and listen, learn and act.

June 11, 2020

Memo to: Oaktree Clients

From: Howard Marks

Re: The Anatomy of a Rally

The background is well known to all.

- On February 19, the U.S. stock market hit a new all-time high, with the S&P 500 reaching 3,386.
- Then investors began to price in the novel coronavirus, causing the market to make its fastest trip ever into bear territory, with the S&P 500 down 34% in five weeks to a low of 2,237.
- That low was reached on March 23, the day the Fed announced a major expansion of its response to the Covid-19-induced shutdown of the U.S. economy.
- Following that, the stock market – along with the credit markets – began a recovery of massive proportions.

The advance started off with a bang – a 17.6% gain for the S&P 500 on March 24-26, the biggest three-day advance in more than 80 years – and by June 8 it had lifted stocks from the low by almost 45%. The market rose on 33 of the 53 trading days between March 24 and June 8, and on 24 of those 33 up days (including the first nine in a row), it gained more than one percent. By June 8, the S&P 500 was down only 4.5% from the February peak and even for the year to date.

I'm writing to take a closer look at the market's rise and where it leaves us. The goal as usual isn't to predict the future but rather to put the rally into perspective.

The questions I get are always indicative of what's going on in investors' minds at the time. Around the early-June high and in the time since, the most frequent ones have been, "How can stocks be doing so well during a severe pandemic and recession?" "Have the securities markets decoupled from reality?" and "Is this irrational exuberance?"

The process of answering these questions gives me an opportunity to dissect the breathtaking market rise. **The world is combatting the greatest pandemic in a century and the worst economic contraction of the last 80+ years. And yet the stock market – supposedly a gauge of current conditions and a barometer regarding the future – was able to compile a record advance and nearly recapture an all-time high that had been achieved at a time when the economy was humming, the outlook was rosy, and the risk of a pandemic hadn't registered. How could that be?**

The possible reasons for the markets' recovery are many and, as I write this memo, the list is growing as people find more things to take positively. (As usual, the higher the market goes, the easier it becomes for investors to find rationalizations for a further rise.) I'll survey the apparent reasons below:

- **Investors placed great credence in the ability of the Fed and Treasury to bring about an economic recovery.** Investors were cheered by the steps taken to support the economy during the shutdown, reopen it, put people back to work and begin the return to normalcy. Everyone understands that the recovery will be gradual and perhaps even bumpy – few people are talking about a powerful V-shaped recovery these days – but a broad consensus developed that recovery is a sure thing.
- As the market recovery took hold, the total number of Covid-19 cases and deaths, and the statistics in states like New York that had experienced the earliest and worst outbreaks, were going in the right direction. Daily new cases declined to very low levels in many places, and the signs of a second-wave rebound were limited. **The curve in most locations clearly had been flattened.**
- In short, the worst fears – things like massive shortages of hospital beds and PPE, and an immediate "second wave" as soon as reopening began – weren't realized. This was cause for relief.
- Rising optimism with regard to vaccines, tests and treatments added to investors' willingness to write off the present episode.
- People became comfortable looking past the pandemic, considering it one-of-a-kind and thus not fundamental. In other words, for some it seemed easy to say, "I'm glad that's over (or soon will be)."
- Positive economic announcements reinforced this conclusion. And the unprecedented extent of the economic carnage in the current quarter made it highly likely that we'll see substantial quarter-over-quarter gains in the next three quarters and dramatic year-over-year comparisons in mid-2021.
- **Thus, overall, investors were glad to "look across the valley" at better times ahead. There will be a substantial dip this year in GDP and corporate earnings, but investors became willing to anticipate a time – perhaps in 2022 – when full-year earnings for the S&P 500 would exceed what they were in 2019 and had been expected to be in 2020.**
- With the outlook now positive, investors likely concluded that they no longer needed to insist on the generous risk premiums afforded by low entry prices, meaning purchase prices could rise.
- **In other words, with regard to economic and corporate developments, investors concluded that it was "all good" or at least heading in the right direction.**

Monetary and fiscal actions made an enormous contribution to the market rebound:

- **The chant went up during the week of March 23: "You can't fight the Fed."** Certainly the evidence convinced investors that interest rates will be what the Fed wants them to be, and the markets will do what the Fed wants them to do. **The higher the market went, the more people believed that it was the goal of the Fed to keep it going up, and that it would be able to.**
- The Fed and Treasury demonstrated their dedication to doing absolutely everything they could think of. Fed Chairman Jay Powell and Treasury Secretary Steve Mnuchin acted

early and dramatically, and Powell's assurances that "we will not run out of ammunition" had a very positive effect.

- The Fed said it would continue buying securities "for as long as it takes," and since its actions suggested it was unconcerned about the ballooning deficits and debt, there was no apparent reason why its ability to keep buying had to have a limit.
- When the Fed buys securities, it puts money into the hands of the sellers, and that money has to be reinvested. The reinvestment process, in turn, drives up the prices of assets while driving down interest rates and prospective returns.
- There's been a related expectation that the Fed's buying might be less than discriminating. That is, there's no reason to believe the Fed insists on good value, high prospective returns, strong creditworthiness to protect it from possible defaults, or adequate risk premiums. Rather, its goal seems to be to keep the markets liquid and capital flowing freely to companies that need it. **This orientation suggests it has no aversion to prices that overstate financial reality.**
- Everyone is convinced that interest rates will be lower for longer. (On June 10, the Fed strongly indicated that there will be no rate increases through 2021 and possibly 2022.)
- Low interest rates engineered by the Fed have a multifaceted, positive impact:

    - The lower the fed funds rate, the lower the discount rate used by investors and, as a result, the higher the discounted present value of future cash flows. This is one of the ways in which declining interest rates increase asset values.
    - **The risk-free rate represents the origin of the yield curve and the capital market line. Thus a low risk-free rate brings down demanded returns all along these continua.** All *a priori* returns on potential investments are viewed in relation to the risk-free rate, and when it's low, even low returns seem attractive.
    - The pricing of all assets is interconnected through these relative considerations. Even if the Fed is buying asset A but not asset B, the rising price and falling expected return on A mean that B doesn't have to appear likely to return as much as it used to, so its price can rise, too. Thus if buying on the part of the Fed raises the price of investment grade debt, the price of non-investment grade debt is likely to follow suit. And if the Fed buys "fallen angels" that have gone from BBB to BB, that's likely to lift the price of B-rated bonds.
    - **Lower yields on bonds means they offer less competition to stocks, etc.** This is yet another way of saying relative considerations dominate. Fewer people refuse to buy just because prospective returns are low in the absolute.

- In all, the Fed created capital market conditions that gave rise to readily available financing, bond issuance at record levels, and deals that were heavily oversubscribed. **As long as money-losing companies are enabled to refinance their debt and borrow more, they're likely to stay alive and out of bankruptcy, regardless of how bad their business models might be.** Zombie companies (debt service > EBITDA) and moral hazard don't appear to trouble the Fed.

Obviously, behavioral factors also had a significant impact:

- Although suspended from February 19 until March 23, the ever-hopeful “buy the dips” mentality and belief in momentum quickly came back to life. **The large percentage of trading in today’s markets accounted for by index funds, ETFs and other entities that don’t make value judgments probably contributes to the perpetuation of trends like these once they’re set in motion.**
- Investors have been cheered by the fact that today’s Fed seems to be offering a “Powell put,” a successor to the Greenspan put of the late 1990s/early 2000s and the Bernanke put induced by the Global Financial Crisis. The belief in the Powell put stems from the view that the Fed has no choice but to keep the markets levitated to reassure financial market participants and keep the credit markets wide open for borrowers.
- **Thus FOMO – fear of missing out – seemed to take over from the prior fear of losing money, a transition that’s always pivotal in determining the mood of the market.**
- Retail investors are said to have contributed substantially to the stock market’s rise, and certainly to its most irrational aspects, like the huge gains in the stock prices of some bankrupt companies. In the exceptional case of Hertz, it seemed for a while that the buoyant stock price might enable the company to sell large amounts of new equity, even though the equity would probably end up worthless. (Equity capital raised by a company in bankruptcy is extremely likely to end up going straight to the creditors, whose improbability of otherwise being paid gave rise to the bankruptcy filing in the first place.) Large numbers of call options have been bought in recent days, and it was reported that small investors accounted for much of the volume. Developments like these suggest the influence of speculative fever and the absence of careful analysis.
- There’s a widely held theory that government benefit checks have been behind some of the retail investors’ purchases. And that makes sense: in the last three months, there’ve been no games for sports bettors to wager on, and the stock market was the only casino that was open.
- **Importantly, fundamentals and valuations appeared to be of limited relevance.** The stock prices of beneficiaries of the virus – such as digital service providers and on-line merchants – approached “no-price-too-high” proportions. And the stocks of companies in negatively affected industries like travel, restaurants, time-sharing and casinos saw massive recoveries, even though their businesses remained shut down or barely functioning. Investors were likely attracted to the former by their positive stories and to the latter by their huge percentage declines and the resulting low absolute dollar prices.

In all these ways, optimistic possibilities were given the benefit of the doubt, making the terms “melt-up” and “buying panic” seem applicable. We saw numerous records smashed in the 11-week recovery of the stock market from its March 23 low.

To sum up and over-simplify, as my partner Bruce Karsh asks in his role as devil’s advocate: can the Fed keep buying debt forever, and can its doing so keep asset prices up forever? **In short, many investors appeared to conclude that it could.**

And on the Other Hand . . .

I'm not going to go to the same lengths in cataloging the negatives that exist today. Especially given their appeal to my cautious bias, I've done so plenty in recent memos. But they certainly have been and are out there:

- The likelihood that, since the U.S. engaged in a more voluntary and less sweeping shutdown than the countries that were most successful in suppressing Covid-19, the reopening of the economy would trigger a second wave of the disease.
- The simultaneous likelihood that, due to fatigue and because many consider "the cure to have been worse than the disease," there won't be the same enthusiasm for a new shutdown, meaning there may be significant stress on the health care system and/or large numbers of fatalities.
- **The possibility that we won't have a vaccine as soon as hoped,** or that it will be limited in its duration or its effectiveness with various strains of the disease.
- The reporting of actual GDP declines on the order of 20-30% for the second quarter and 5-10% for the full year, and of an unemployment rate around 10% in late 2020 and into 2021.
- **The impact on the economic recovery if the return to work is slow, large numbers of small businesses never reopen, and millions of jobs turn out to be permanently lost.** In particular, the slow return of customers and the regulations that limit the scale of operation may prevent newly opened public-facing businesses from being much more profitable than they were when they were fully closed.
- Worry that political or financial considerations will keep the Fed and/or Treasury from renewing their monetary and fiscal tools to combat the economic slowdown.
- The significant long-term damage done to state and city finances.
- The likelihood that there'll be widespread defaults and bankruptcies despite the Fed and Treasury machinations.
- **The impact of potentially permanent changes to business models in industries like retail and travel, and on office buildings and high-density urban centers.**
- The possibility of increased inflation (or, some say, deflation), long-term damage to the reserve status of the dollar, a downgrade of the U.S. credit rating, or an increase in the cost to finance our vastly expanded deficits.

There are always positives and negatives, and we can list them, consider their validity and try to assess what they boil down to. But what matters most at a given point in time in determining market behavior is which ones investors weight most heavily. Following the March 23 low, the emphasis certainly was on the positives.

Does It Make Sense?

Yes, there had been something approaching a selling panic between mid-February and late March in response to the pandemic, with the S&P 500 collapsing and the yields on high yield bonds tripling in just four and a half weeks. And yes, the Fed and the Treasury seem to have averted a depression and put us on the path to recovery. **But was there justification for the stock market's 45% gain from the low and the halving of high yield bond yields from their high? And were the resulting security prices appropriate?** In other words, some recovery was not unreasonable, but was the magnitude of the one that occurred justified?

Of course, the answers to these questions lie in the eye of the beholder. If there were a straightforward, reliable and universally accepted way to arrive at appropriate security prices, (a) securities would likely sell at or near those prices and (b) over-optimistic highs and over-pessimistic lows wouldn't be reached. But the most optimistic psychology is always applied when things are thought to be going well, compounding and exaggerating the positives, and the most depressed psychology is applied when things are going poorly, compounding the negatives. This guarantees that extreme highs and lows will always be the eventual result in cycles, not the exception. (For a few hundred pages more on this subject, see my 2018 book, *Mastering the Market Cycle: Getting the Odds on Your Side*.)

Maybe it's the increased availability of information and opinion; maybe it's the popularization of investing; and maybe it's the vastly increased emphasis on short-term performance. But for whatever reason, things seem to happen faster in the markets these days. That certainly has been true in the last four months. In the current episode, the 34% decline from the all-time high to the crisis low took less than five weeks, and the 45% recovery to the June 8 high took only 11 weeks. These fluctuations were incredibly swift and powerful.

In my memo, *On the Couch* (January 2016), I wrote that:

> That's one of the crazy things: in the real world, things generally fluctuate between "pretty good" and "not so hot." But in the world of investing, perception often swings from "flawless" to "hopeless."

Thus far in 2020, the swing from flawless to hopeless and back has taken place in record time. The challenge is to figure out what was justified and what was aberration.

The Bottom Line

I tend to return to a select few investment adages to make my points, for the simple reason that these time-honored standards contain so much wisdom. And I've written often about the first one shared with me by an experienced investor in the mid-1970s: the three stages of a bull market. There's a usual progression in market advances according to this beauty, and as far as I'm concerned, it's absolutely accurate and fully captures the reality:

- the first stage, when only a few unusually perceptive people believe improvement is possible;
- the second stage, when most investors realize that improvement is actually taking place; and

- the third stage, when everyone concludes everything will get better forever.

Looking back (which is the main way we know these things), the first stage began in mid-March and culminated on March 23. Certainly very few people were thinking about economic improvement or stock market gains around that time. Then we passed briefly through stage two and went straight to stage three.

Certainly by the time the interim high was reached on June 8, it felt like the market was being valued in a way that focused on the positives, swallowed them whole, and overlooked the negatives. That's nothing but a value judgment on my part. It's just my opinion that the imbalance of attention to – and blanket acceptance of – the positives was overdone.

I had good company in being skeptical of the May/June gains. On May 12, with the S&P 500 up a startling 28% from the March 23 low, Stan Druckenmiller, one of the greatest investors of all time, said, "The risk-reward for equity is maybe as bad as I've seen in my career." The next day, David Tepper, another investing great, said it was "maybe the second-most overvalued stock market I've ever seen. I would say '99 was more overvalued."

On the days those two spoke, both the plain vanilla forward-looking p/e ratio and the Shiller cyclically adjusted price-to-earnings ratio were well above normal levels, disregarding all the uncertainties present and the big declines that lie ahead for GDP and earnings.

And yet, over the next four weeks leading up to the June 8 high, the S&P 500 rose an additional 13%. What this proves is that either (a) "overpriced" isn't synonymous with "sure to decline soon" or (b) Druckenmiller and Tepper were wrong. I'll go with (a). On June 8, Druckenmiller described himself as "humbled." (In this line of work, if you never feel humbled, it just means you haven't realistically appraised your performance.) All I know is that a lot of smart, experienced investors concluded that asset prices had become too high for the fundamentals. Time will tell.

* * *

There's no way to determine for sure whether an advance has been appropriate or irrational, and whether markets are too high or too low. But there are questions to ask:

- Are investors weighing both the positives and the negatives dispassionately?
- What's the probability the positive factors driving the market will prove valid (or that the negatives will gain in strength instead)?
- Are the positives fundamental (value-based) or largely technical, relating to inflows of liquidity (i.e., cash-driven)? If the latter, is their salutary influence likely to prove temporary or permanent?
- Is the market being lifted by rampant optimism?

- Is that optimism causing investors to ignore valid counter-arguments?
- How do valuations based on things like earnings, sales and asset values stack up against historical norms?

Questions like these can't tell us for a fact whether an advance has been reasonable and current asset prices are justified. But they can assist in that assessment. **They lead me to conclude that the powerful rally we've seen has been built on optimism; has incorporated positive expectations and overlooked potential negatives; and has been driven largely by the Fed's injections of liquidity and the Treasury's stimulus payments, which investors assume will bridge to a fundamental recovery and be free from highly negative second-order consequences.**

A bounce from the depressed levels of late March was warranted at some point, but it came surprisingly early and quickly went incredibly far. The S&P 500 closed last night at 3,113, down only 8% from an all-time high struck in trouble-free times. As such, it seems to me that the potential for further gains from things turning out better than expected or valuations continuing to expand doesn't fully compensate for the risk of decline from events disappointing or multiples contracting.

In other words, the fundamental outlook may be positive on balance, but with listed security prices where they are, the odds aren't in investors' favor.

June 18, 2020

Legal Information and Disclosures

Memo to: Oaktree Clients

From: Howard Marks

Re: Time for Thinking

In the early weeks and months of the novel coronavirus pandemic and the related shutdown of the economy, the pace of economic and health developments was frenetic. My memo writing followed suit: one a week for the first six weeks, and a total of ten over 18 weeks. After starting off at that rapid clip, I haven't issued a memo in more than a month – which might seem like a long interval until you realize the norm in recent years has been only one per quarter.

The pace of events has certainly slowed over the last month or two, to the point where most of us are struck by the sameness of our days. We stay in one place for both work and leisure; weekdays aren't very different from weekends; and the idea of vacation seems almost irrelevant: where would we go and what would we do? My acronym of choice is SSDD, the family-friendly translation of which is "same stuff, different day."

But the slower pace of developments allows for more rumination, and I've come up with some thoughts about our present circumstances.

The Health Crisis

Earlier this month, I prepared a presentation for one of our sovereign-wealth-fund clients. Their annual forum had been expected to entail the last bit of foreign travel still on my calendar, but of course I participated by video conference instead. I started my PowerPoint presentation with the following metaphor:

To deal with particularly serious diseases, doctors sometimes have to take extreme action to save the patient: they induce a coma to permit the administration of harsh remedies, maintain life support, treat the disease, and bring the patient back to consciousness.

In the case of Covid-19, one of the worst pandemics of the last century, policymakers were similarly required to take desperate measures. Upon the eruption of the disease, epidemiologists told us it would spread exponentially, possibly killing millions.

In the absence of a vaccine, the only way to deal with the outbreak was to prevent those who had contracted the disease from spreading it to others. In order to do so, the authorities decided it was necessary to put the patient into a coma. Thus the economy was shut down to minimize interpersonal contact. Stores, restaurants, schools, places of worship, and entertainment and sports venues were ordered closed, travel was restricted, and people were told to work from home whenever possible. As we all know, the U.S. economy was largely frozen, causing 54 million Americans to file for unemployment benefits since March 21 and second-quarter GDP to shrink by an annualized 32.9%, three times the greatest quarterly decline in the 70 years of recorded quarterly history. (Please see the end of this memo for postscript in which I discuss the significance of that reported 32.9% decline.)

The comatose patient – the economy – required life-support, and the Fed and Treasury supplied it. They rushed in with trillions of dollars to keep the patient alive: payments to individuals and households; grants to distressed industries; general business loans and tax relief; loans to small businesses; aid to states, hospitals and veterans' care; and guarantees for money market funds and commercial paper. These are sometimes described as stimulus programs, but that's a misnomer: they were support payments designed to replace cash that normally would have circulated throughout the economy.

With the economy comatose and on life support, elected officials proceeded to administer the cure. In the absence of a vaccine, this was designed to take the form of testing to identify those who had the disease and tracing to identify those with whom they'd come into contact; quarantining and social distancing to keep them separate from others; and masking to prevent the asymptomatic sick from infecting the healthy.

When the number of new cases, hospitalizations and deaths declined, and in view of the desirability of allowing economic activity to resume, those in charge turned to resuscitating the patient. The economy began to reopen in May, supported by a near-zero base interest rate and the Fed's provision of abundant liquidity, and the initial response was positive. Retail sales moved up 17.7% in May (after a 22.3% decline in March/April), and the unemployment rate fell to 11.1% in June, from a peak suspected to have been near 20%. Case closed.

<u>Failure to Fix It</u>

If only it was that simple. Unfortunately, in some instances the reopening took place before the number of new cases had declined enough for the spread of Covid-19 to be brought under control, and people in areas that had been spared in the early days acted cavalierly, allowing the disease to regain a foothold in their regions. Borrowing from Churchill (who probably borrowed it from Machiavelli), people who regulate economies and manage businesses say "never let a good crisis go to waste." **But in the case of Covid-19, the U.S. did just that.**

The nations of Asia and Europe had the earliest outbreaks, but they took swift and stern action – some say Draconian – including enforcing isolation and fining violators. But they got the disease under control. Unfortunately, a number of elements combined to weaken the actions taken in the U.S. and permit a resurgence of the disease:

- The absence of uniform national policies on shutdowns, social distancing, masking and re-opening.
- Inadequate support for the recommendations of health professionals and scientists.
- The foolhardiness of youth, who were misled by early statistics into believing they were immune.
- "National hubris and belief in American exceptionalism," according to Martha L. Lincoln, a medical anthropologist and historian. As one of our elected leaders stated on March 11, "The virus will not have a chance against us."

- The turning of masking and social distancing into partisan issues, raising suspicion that the virus is a hoax and protective rules an infringement of personal freedom.
- The politicization of the difficult choice between reopening the economy and minimizing infections. The states currently seeing the greatest increases in new cases are mostly ones that emphasized the former over the latter.

Clearly, society reopened and people began to congregate before the virus was reduced to controllable levels, allowing it to reemerge. And shutting down to fight the disease in some locations but not others was dangerous when people can travel freely among them. Now contact tracing – a very important weapon in the arsenal of the countries that got the spread of Covid-19 under control – is said to have been rendered useless in the U.S. by the sheer number of people who've been infected.

So rather than the desired progression of infection, coma, life support, treatment, cure and resuscitation, we've had a progression of infection, coma, life support, treatment and resuscitation. **The cure is missing.** Because much of America reopened before the disease was brought fully under control, the early lockdowns went to waste, and the current number of daily new cases far exceeds that of March and April. RockCreek Group's July 27 report put it well:

> By reopening when COVID-19 was still spreading and pervasive in many places, the US may have gotten the worst of both worlds: a sharp recession, which will leave scars in terms of business closures, bankruptcies and disrupted lives, and continued disease, that will be difficult if not impossible to eradicate, in the absence of effective treatments and vaccines.

Thus, on July 30, *The New York Times* reported as follows:

> "The path forward for the economy is extraordinarily uncertain and will depend in large part on our success in keeping the virus in check," [Fed Chairman Jerome] Powell said at a news conference following the Fed's two-day meeting, noting that **infections have surged since late June and the "pace of recovery looks like it has slowed."**
>
> Mr. Powell said policymakers needed more data before drawing firm conclusions about the scope of the pullback, but he noted that **debit and credit card spending were slowing and labor market indicators suggested that recent job gains might be weakening**. (Emphasis added)

Not a Cycle

Two of the questions I get most often these days are, "What kind of cycle are we in?" and "Where do we stand in it?" My main response is that the developments of the last five months are non-cyclical in nature, and thus not subject to the usual cycle analysis.

The normal cycle starts off from an economic and market low; overcomes psychological and capital market headwinds; benefits from gathering strength in the economy; witnesses corporate results that exceed expectations; is amplified by optimistic corporate decisions; is reinforced by increasingly positive investor sentiment; and thus fosters rising prices for stocks and other risk assets until they become excessive at the top (and vice versa on the downside). **But in the current case, a moderate recovery – marked by reasonable growth, realistic expectations, an absence of corporate overexpansion and a lack of investor euphoria – was struck down by an unexpected meteor strike.**

People also ask what's different about this episode from those I've lived through in the past.

- As described above, the normal cyclical progression of ups and downs – and the normal series of events, each of which causes the next – had nothing to do with it. The current downturn didn't result from excessively optimistic business decisions or too-high growth expectations that were disappointed, but rather from an exogenous event that brought a sudden end to the expansion. Thus the factors that result in and normally characterize a cyclical recovery – most of all the recognition that negativism is excessive and stimulative measures are required to turn things around – are unlikely to do the trick this time. Since the root cause of the current problem is medical rather than economic, merely cutting interest rates and flooding the economy with liquidity may not kickstart a recovery as usual. Rather, the virus has to be brought under control.

- Additionally, there may be permanent changes to our way of life – altering things like travel, business's reliance on offices, and activities involving crowds – that affect the path of recovery.

- Something else that keeps me from thinking about the coming months as a normal recovery is that just five months after the onset of the pandemic in the U.S., and just a few months after the bottom was reached in the market and the economy, investor optimism has been restored and the prices of many assets have regained their prior highs. That's a much faster recovery than normal by historic standards, and it seems to give short shrift to the conditions that continue to challenge the economy.

- Lastly, the effects this time are highly uneven, with people of color and low-income Americans affected disproportionately, at a time of heightened sensitivity to this issue. They're more likely to have lost their jobs and less likely to have enjoyed gains in net worth from asset appreciation – not to mention their higher rates of infection and death due to the pandemic. Whites and white-collar workers and professionals, on the other hand, are more likely to have kept their jobs and to have benefited from asset price inflation through home ownership and participation in the stock market.

I'm convinced cycles will continue to occur over time, highlighted by excessive movements away from "normal" and toward extremes – both high and low – that are later followed by corrections back toward normalcy, and through it to excesses in the opposite direction. **But that's not to say that every event in the economy or markets is cyclical. The pandemic is not.**

<u>What Shape Are We In?</u>

Another frequent question is, "What shape will the economic recovery take?" Everyone has his or her favorite candidate: a W, an L, a U or maybe a Nike Swoosh. Of course, the one we hear the most about is a V. While the terminology used isn't crucial, and may basically be just a matter of semantics, I find the label "V-shaped" misleading.

Of all the people who use the label "V-shaped" to describe this recovery, I don't think I've ever seen anyone define it. To me, a "V" has to satisfy two important requirements:

- First, the essential nature of the pattern has to be **down-and-up**, meaning it doesn't spend much time skating along the bottom. One that stays down for a while, on the other hand, would be called U-shaped or what in the 1970s we called saucer-shaped.
- Second, when I hear "V," it seems to me the two sides should be basically **symmetrica**l. That is, the economy should come back at a rate similar to that at which it went down.

That second criterion makes me doubt that the current recovery will be a V. The U.S. economy deteriorated in the second quarter at the highest annualized rate in history, almost 33%, and it's certainly not going to come back at the same rate (leaving aside the fact that it takes a 49% gain to offset a 33% decline).

Most observers seem to think quarterly U.S. GDP will regain its level in the corresponding quarter in 2019 sometime between the fourth quarter of 2020 and the middle of 2021. That means it'll take at least until 2021 for annual GDP to equal or exceed 2019's. Whereas I think history will show that the decline took place over just a few months (perhaps only February, March and April), the recovery may take 8 to 14 months. And the rate of unemployment is unlikely to return to its recent low of 3.5% for years, if ever.

- The renewed spike of Covid-19 cases has caused the reopening of the U.S. economy in some areas to be delayed or reversed.
- The emergence of politics as the general election approaches decreases, in my opinion, the likelihood that future support payments will be as generous as the early rounds.
- People with the choice may not return to the office for several months, holding back both overall productivity and the recovery of businesses that exist to serve office populations.
- People who are reliant on mass transit to commute to work – or on schools to care for their kids – may be slower to return to work than they otherwise would be.
- Some industries whose business models have been affected – like airlines, resorts and entertainment – may take years to recover to their prior levels.
- Many restaurants and other small businesses may never reopen.
- With industries evolving, more being done digitally and management teams having had an opportunity to watch their companies function with fewer people, some jobs may never return.
- Finally, the pandemic has accelerated preexisting trends such as automation and the decline of brick-and-mortar retail, and thus their contribution to job losses.

Fast down and slow up: to me, that's no V. I prefer to think of it as a checkmark, like this: 

The Markets and the Fed

The U.S. stock market continues its ascent, and as measured by the S&P 500, it's just about back to where all this started: the all-time record of 3,386 attained on February 19. The market for corporate credit has been strong as well. Here's the macro situation, hopefully reduced to the bare essentials:

The positives:

- The reduction of interest rates to near zero has increased the value of investment assets and spurred a global bidding war that has raised their prices.
- The Fed has flooded the economy and the markets with liquidity and other forms of support for individuals, companies and institutions.
- The Fed and the Treasury seem willing to provide support and stimulus well into the future.

The negatives:

- The economy has suffered the greatest quarterly setback in history.
- Covid-19 still isn't under control.
- A second spike is complicating efforts to re-open the economy.

In short, titanic forces are arrayed against each other: Fed and Treasury versus disease and recession. Which will win?

No one knows about the long run, but it's clear which has come out on top so far. Lower interest rates increase the discounted present value of future cash flows and reduce the *a priori* return demanded from every investment. In layman's terms, when the fed funds rate is zero, 6% bonds look like a giveaway, so buyers bid them up until they yield less (thus I believe 97% of outstanding bonds yield less than 5% today, and 80% yield less than 1%). And Fed buying drives up the price of financial assets and puts money into sellers' hands with which they can buy other assets, further elevating prices. For all these reasons, monetary actions have come out on top so far, validating the old maxim that "you can't fight the Fed."

But what does it mean if the prices of stocks and listed credit instruments are where they are not primarily for fundamental reasons – such as current earnings and the outlook for future gains – but rather in large part because of the Fed's buying, its injection of liquidity, and the resultant low cost of capital and low demanded returns? **If high asset prices are substantially the result of tailwinds from technical factors such as these, does it mean those actions have to be continued in order for asset prices to remain high, and that if the Fed reduces its activity, those prices will fall? And that leads to the ultimate question (as Bruce Karsh seems to ask daily): can the Fed keep it up forever?** Are there any limits on its ability to create bank reserves, buy assets and expand its balance sheet? And are there limits on the Treasury's willingness to run deficits, now that it has taken this year's to $4 trillion and shown an inclination to go well beyond that?

Since I'm out of my depth regarding the last three questions, I've again turned to my friend Randall Kroszner, Deputy Dean for Executive Programs at the University of Chicago Booth School of Business. From 2006 to 2009, Randy was a member of the Board of Governors of the U.S. Federal

Reserve System and accordingly a voting member of the Federal Open Market Committee. Here's his reply:

> There is no limit on the ability of a central bank to create reserves, as long as someone is willing – or through government edicts, forced – to take them. This was true in the extreme circumstances of Weimer Germany, Brazil in the 1970s/80s, and it is true Zimbabwe today, as well as in the much more benign current situation in Japan. The key question is the impact of that reserve creation on money supply and the demand for money. Treasury's appetite for deficit financing will remain high as long as real and nominal interest rates remain low.

In the last five months, the Fed has swollen its balance sheet by $3 trillion and the Treasury has added $3 trillion to the expected deficit, for a total increase of liquidity in the economy of $6 trillion, probably with more to come. It's normal to assume that an increase in liquidity on that order will increase the demand for goods relative to the supply, bringing on increased inflation, as it already has for financial assets. (Note, however, that even with interest rates low for a decade and near zero today, inflation hasn't come close to the Fed's target of 2%. If growth remains weak and inflation stays low, the Fed is likely to believe it can continue an activist regime.) Here's Randy Kroszner's view:

> I think this is the key point: whether it is Japan, where the BoJ's balance sheet exceeds 100 percent of GDP and continues to grow rapidly, or the ECB with a balance sheet of more than 50 percent of Eurozone GDP and growing, or the Fed with a balance sheet of just over a third of US GDP and growing, inflation has been below the 2 percent target, and expectations of inflation over short and long horizons remain low. Even when the U.S. was growing 2-3 percent pre-Covid, we didn't see an uptick in inflation or inflation expectations. As long as there continues to be a very large demand for super liquid safe assets like bank reserves and cash, the central banks can maintain large balance sheets – and even increase them – without a sharp increase in money supply that ignites inflation. The ongoing uncertainty over the course of the virus and the policy responses will undoubtedly keep the demand for safe liquid assets high for some time.

It's also normal to assume that monetary expansion like this can lead to a weaker dollar, downgrades of the U.S.'s creditworthiness by rating agencies, higher interest costs on national debt, and/or jeopardy to the dollar's status as the world's reserve currency. All these things could increase the difficulty of servicing the U.S.'s expanded national debt, feeding back into still-higher deficits. **This isn't pie-in-the-sky, since between March (when the Fed/Treasury programs were announced) and the end of July, the dollar depreciated by 9% versus a basket of currencies.** That could be related to the dollar's tendency to benefit from flight to quality, which probably reached its apex in March, and to do less well when fear recedes. But it's still down 3% for the year to date and particularly weak in July.

These are the traditional concerns with regard to monetary expansion. Modern Monetary Theory ("MMT") stands ready to refute them. The actual outcome is unknowable. **But does it really make sense that bank reserves, the Fed balance sheet and the federal deficit can be increased *ad infinitum* without negative effects?** My answer is the usual: we'll see. But I'll let Randy Kroszner have the last word on the subject:

> I always find it difficult to understand MMT – it seems to suggest that there isn't a budget constraint. I'm very old-fashioned about that and still believe in them. Countries like Argentina, Zimbabwe, etc. show that the less "modern" monetary theory still applies, at least in those places. **There is a delicate balancing act: Markets certainly allow credible governments like Japan and the US to borrow enormous amounts without much concern, but the key issue is what could undermine that credibility? If that does happen, the consequences certainly could be titanic.** (Emphasis added)

The Bull Case

One thing the pandemic has given many of us is lots of time for reading and thinking, and I've had a chance to bone up on some of the arguments supporting current stock and bond market prices. Given my "value" leanings and acknowledged conservative bias, I found it a valuable process. And it was important to undertake it, since it certainly can't be said that caution regarding the damaged economy and elevated p/e ratios has been rewarded of late.

As for the stock market, several points are advanced to justify the current level – which is so mystifying to value investors – and assert its bright future:

The first is that many investors have underestimated the impact of low rates on valuations. In short, what should the stock market yield? Not its dividend yield, but its earnings yield: the ratio of earnings to price (that is, p/e inverted). Simplistically, when Treasurys yield less than 1% and you add in the traditional equity premium, perhaps the earnings yield should be 4%. That yield of 4/100 suggests a p/e ratio (the inverse) of 100/4, or 25. Thus the S&P 500 shouldn't trade at its traditional 16 times earnings, but roughly 50% higher.

Even that, it's said, understates the case, because it ignores the fact that companies' earnings grow, while bond interest doesn't. Thus the demanded return on stocks shouldn't be (bond yield + equity premium) as suggested above, but rather (bond yield + equity premium - growth). If the earnings on the S&P 500 will grow to eternity at 2% per year, for example, the right earnings yield isn't 4%, but 2% (for a p/e ratio of 50). And, mathematically, for a company whose growth rate exceeds the sum of the bond yield and the equity premium, the right p/e ratio is infinity. **On that basis, stocks may have a long way to go.**

The rest of the bulls' arguments mostly surround the exceptional nature of the market-leading tech companies:

- They grow much faster than the large companies of the past, and their growth is much less likely to prove cyclical.
- In fact, the current crisis, with the accompanying movement on-line of a larger share of everyday life, has (a) served to accelerate their growth or (b) given them an opportunity to demonstrate their ability to grow regardless of conditions in the environment.
- They have scale, technological advantages and network effects that give them much greater protection against competition than their old-economy predecessors enjoyed.

(Correspondingly, however, regulatory efforts to restrain their market power represent their greatest risk.)

- Thanks to the role of intellectual property as the main "raw material" in their products, most of these companies can create additional units for sale at very low marginal cost.
- Likewise, they can grow without much additional capital, if any (all five of the top tech firms are in a "net cash" position, meaning their cash holdings exceed their debt).
- Finally , their high p/e ratios today mean less than usual, since these tech champions are vastly under-reporting earnings: if they were to cut back on things like customer-acquisition costs and R&D and settle for lower (but still rapid) growth, they could report far higher earnings.

Thus, it's said, the skeptics seriously underestimate the ability of the technological leaders to grow, and to pull up the overall growth rate for the universe of common stocks. They grow every day, and so does their representation in the equity indices and in corporate America, creating a virtuous circle.

Thus, with these dominant large-cap tech companies making up a large and growing percentage of the stock market, to be bearish one has to have a thesis on why they should fall. Or else you would have to bet on the non-tech sectors to decline a great deal and pull down the averages – despite the fact that they're already down a lot.

The S&P 500 is basically flat on the year, but without FAAMG (Facebook, Apple, Amazon, Microsoft and Google, its five heaviest-weighted components) and other tech/software stocks, it would be considerably lower. (The top five are up by an average of 36% so far this year, while the median change for all 500 stocks is minus 11%.) Does it make sense that the FAAMG-plus-tech/software stocks are up a lot in this context? It seems that it does, because (a) Covid-19 has accelerated tech adoption in many ways, and thus these companies' growth, and (b) today's ultra-low interest rates justify much higher p/e ratios (see above). If instead the tech giants were flat against this backdrop – or had just performed in line with the rest of the index – we'd probably say something was wrong.

I don't know whether these bullish arguments are absolutely correct or merely have gained luster thanks to their having driven the 46% gain of the S&P 500 over the last four months. Regardless, I want to share the bull case as a public service and because it has obvious merit . . . and certainly has won out thus far.

*   *   *

So let's try to find a bottom line:

- **On one hand, we have the surprisingly rapid recovery of the stock and credit markets to roughly their all-time highs**, despite the fact that the spread of Covid-19 hasn't been halted, and that it will take a good number of months for the economy to merely return to its 2019 level (and even longer for it to give rise to the earnings that were anticipated at the time those market highs were first reached). Thus p/e ratios are unusually high today and debt yields are at unprecedented lows. Extreme valuations like these are usually justified with protests that "this time it's different," four words that tend to get investors into trouble.

- **On the other hand, John Templeton allowed that when people say things are different, 20% of the time they're right.** And in a memo on this subject in June of last year, I wrote, "in areas like technology and digital business models, I'd bet things will be different more than the 20% of the time Templeton cited." It certainly can be argued that the tech champions of today are smarter and stronger and enjoy bigger leads than the big companies of the past, and that they have created virtuous circles for themselves that will bring rapid growth for decades, justifying valuations well above past norms. Today's ultra-low interest rates further justify unusually high valuations, and they're unlikely to rise anytime soon.

- **But on the third hand, even the best companies' stocks can become overpriced**, and in fact they're often the stocks most likely to do so. When I first entered the business in 1968, the companies of the Nifty Fifty – deploying modern wonders like computing (IBM) and dry copying (Xerox) – were likewise expected to outgrow the rest and prove impervious to competition and economic cycles, and thus were awarded unprecedented multiples. In the next five years, their stockholders lost almost all their money.

For these reasons and more, I find today's stock and credit markets opaque . . . as usual.

We reach our conclusions, limited by the inadequacy of our foresight and influenced by our optimistic or pessimistic biases. And we learn from experience how hard it is to get the answer right. That leads me to end with a great bit of wisdom from Charlie Munger concerning the process of unlocking the mysteries of the markets: "It's not supposed to be easy. Anyone who finds it easy is stupid."

August 5, 2020

P.s.: We were all struck by the enormity of the reported decline in second quarter real GDP. **Before now, no one's ever seen an economy contract by one-third in three months!** However, thinking about the results in connection with writing this memo raised some questions:

- I had immediately assumed Q2 GDP was down $1.81 trillion, or 32.9%, from Q2 of last year. But the actual decline was only $0.45T, from $4.76T to $4.31T, or 9.5%.
- Could it have been a decline of $1.81T from Q1's $4.63T, bringing Q2 GDP to $2.82T? But going from $4.63T to $2.82T would mean a decline of 39.1%. And anyway, that couldn't have been the case, since actual Q2 GDP was $4.31T.
- Or was it a projected drop of $1.81T from actual 2019 full-year GDP of $19.09T? No, that would represent a decline of only 9.5%.

I couldn't make sense of the numbers, so I consulted Conrad DeQuadros of Brean Capital for help understanding them. I found his answer surprising, and you might as well.

Have you thought about what the reported 32.9% decline in second quarter GDP really means? Answer: **it's the percentage by which 1Q2021 GDP would be below 1Q2020 GDP if GDP were to decline in the next three quarters at the same rate as it did in 2Q2020.** If that seems incredibly complex, so was Conrad's explanation:

- Actual second quarter real GDP (without seasonal adjustment or annualization) was $4.31 trillion. That was down 7.0% from $4.63T in Q1 on the same basis.
- If the three subsequent quarters were also down 7.0% from quarter to quarter, 3Q2020 would be $4.00T, 4Q2020 would be $3.72T, and 1Q2021 would be $3.46T. (These are figures you'd never see, since they omit seasonal adjustment, annualization and adjustment for inflation. But I think they present a fair if not technically correct picture for these purposes.)
- **It's that figure of $3.46T for 1Q2021 GDP that – after annualization and adjustments for seasonality and inflation – would be 32.9% below GDP in 1Q2020.**
- Interestingly, after the assumed declines, GDP in the four quarters 2Q2020 through 1Q2021 (as enumerated above) would sum to $15.49T for the year. But that would be down only 18.9% from the actual total of $19.11T in the four prior quarters (2Q2019 through 1Q2020).

So, again, the 32.9% reported decline in Q2 is the difference between 1Q2020 GDP and projected 1Q2021 GDP assuming quarterly GDP continues to fall at the 2Q2020 rate. But nobody expects that to happen. Which means the 32.9% is a highly misleading, exaggerated figure. **Nothing went down by one-third, and nothing is likely to do so.**

It's the same for nominal GDP. The decline in GDP from 1Q2020 to 2Q2020 was reported as $2.15T, or 34.3%, but those also are annualized figures. The $2.15T decline is the difference between 1Q2020 annualized GDP of $21.56T and 2Q2020 annualized GDP of $19.41T. But the decline in actual quarterly nominal GDP from Q1 to Q2 was only $0.38T (from $5.25T to $4.87T), or 7.2%. So what do the reported annualized Q2 declines of $2.15T and 34.3% mean? Also nothing.

In the business world, we'd be looking at the relationship between GDP in 2Q2020 and what it was in 2Q2019. As mentioned above, real Q2 GDP fell from $4.76T in 2019 to $4.31T in 2020, for a decline of 9.5%. Nominal Q2 GDP fell from $5.36T in 2019 to $4.87T in 2020, down 9.1%. **Obviously, neither of these year-over-year declines bears any resemblance to the reported 32.9% decline.**

Here's Conrad's conclusion:

> Annualization is useful in normal times for comparing a quarter to the recent prior years, but not very useful for current circumstances. . . . Most other major economies do not report annualized changes in GDP (for example, when the change in Eurozone GDP is reported [on August 3], it will be a non-annualized change). It is not reasonable to expect the second quarter's drop to continue for a year.

Finally, at year-end, the GDP that's reported for each year is the sum of the actual dollar GDP in its four quarters (without annualization or seasonal adjustment). **Thus, when GDP is reported for 2020, it's unlikely to show a decline of 32.9% or anything like it.** After reported quarter-over-quarter declines in annualized GDP of 5.0% in Q1 and 32.9% in Q2, Morgan Stanley (for example) expects increases of 21.3% in Q3 and 0.3% in Q4. If we were to chain those quarterly percentage changes, as we do with quarterly portfolio returns, we would get a decline for the year of 22.5%. Or if we (incorrectly) added them together, ignoring the impact of compounding, we would get a decline of 16.3%. **But MS expects full-year 2020 GDP to be down only 5.3% year-over-year and 6.2% Q4-over-Q4.**

So what I've learned is that annualized quarter-over-quarter changes are quite meaningless, **including Q2's reported decline of 32.9%.**

Legal Information and Disclosures

Memo to: Oaktree Clients

From: Howard Marks

Re: Coming into Focus

Roughly two months have passed since my last memo, *Time for Thinking*, and still not much has changed in the economy or the markets. The toll from Covid-19 continues to rise, the economic outlook is largely the same, vaccines remain some time off, and the S&P 500 is back where it was in early August. So I'll repeat what I said then: it's mainly been time for thinking. Fortunately, the more I've thought about the issues, the more things have come into focus for me. Thus, I'm going to use this memo to go into greater detail on a few topics.

The Prerequisite

In *Time for Thinking* I talked about the fact that I don't consider this year's developments to be cyclical. You could say, "Why not? The economy and the markets went down, and now they're recovering. Isn't that a cycle?" What I really mean is that this is very different from a normal cycle, and I've figured out a way to better explain that, borrowing a bit of what I said in my 2018 book, *Mastering the Market Cycle*.

Most of the up-cycles I've witnessed occurred because things were going well in the economy, causing psychology and decision-making to become increasingly optimistic and eventually euphoric. Corporations favored expansion, stock prices rose and financial innovation became possible, even encouraged. Eventually, productive capacity exceeded what was needed, stock prices exceeded underlying value, and shaky investment innovations were embraced. When these trends outstripped the fundamentals and became unsustainable, the result was a downturn. Often a recession triggered a market correction, and sometimes the impact of that recession was reinforced by negative exogenous events that further darkened the previously-blue skies.

A good example is the first non-investment grade debt crisis Bruce Karsh and I managed through, in 1990-91. There was a recession, exacerbated by the shock of going to war to help Kuwait repel an invasion by Iraq. The newly developed high yield bond market experienced its first major spate of defaults, the result of a recession and credit crunch and exacerbated by the prosecution of Michael Milken and the failure of Drexel Burnham, precluding remedial bond exchanges that otherwise might have helped companies stay alive. Stocks declined, but high yield bonds went into free-fall. Notably, many of the prominent LBOs of the 1980s – which had been financed with perhaps 95% or so of debt – went bankrupt. Investor psychology collapsed and bondholders headed for the exits.

A collapsing economy needs a good dose of stimulus to pull it out of its swoon, and that's what occurred. Usually that's enough. Eventually the economy recovers; consumers resume buying; investors regain their equilibrium – some even sense the bargains that have been made available; and the upswing takes the economy back toward good health . . . and the cyclical process continues.

So, most of the time, downturns stem primarily from economic weakness, and they are repaired with economic tools. But this episode is different. It was caused by an exogenous, non-economic development, the pandemic. The recession – rather than being the cause – was the result: a closure of business induced intentionally in order to minimize inter-personal contact and halt the spread of the disease.

Thus, this down-cycle cannot be fully cured merely through the application of economic stimulus. Rather, the root cause has to be repaired, and that means the disease has to be brought under control. An effective vaccine will do this – in time – but healthy behavior will be required in the meantime. Spikes like much of Europe is seeing represent something of a step backward in this regard.

And even with the disease controlled, economic stimulus is unlikely to reverse all the damage. The trauma has been deep, and the impact may not be easily shaken off. Large firms will continue to automate and streamline. Large numbers of smaller businesses – such as restaurants, bars and shops – will never re-open. Thus millions of people will not be rehired into the jobs they formerly held. For this reason, the expectations with regard to economic recovery have to be realistic. To me, as I've said, "V-shape" has too positive a connotation.

<u>The Need for Further Assistance</u>

One of the things weighing on the recovery is the matter of help from Washington. Whereas the Treasury was able to announce aggressive spending programs in the spring, there has been no new package here in the fall. Partisan differences have arisen regarding the size of a package and its contents. Further, we're so close to the upcoming election – less than a month away – that neither side wants to give the other anything that might be described as a victory.

But this is not an academic matter. The trillions of dollars paid out thus far were not stimulus payments, but support. They weren't made to get the recipients to spend so much as to keep them and the economy alive. In short, the amounts distributed – to the unemployed, families with incomes below $100,000, companies and institutions – were designed to replace lost income and maintain, rather than stimulate, the economy. Individuals got money so they could buy the necessities of life. Companies got money to replace lost revenues, so they could continue to employ people. These needs have not dried up, even as the disease has ground on and the supplemental unemployment benefits have expired.

As one of my Oaktree colleagues wrote me last week, "I was chatting today with the owner of a small movie theater chain. One wouldn't trade places. All of their theaters in California are closed; the ones out of state are operating with high costs and no patrons; and there is virtually no product to attract audiences. And the lenders and landlords are banging on the door."

Individuals have problems, too. According to *Morning Brew* on September 25:

> With the economy still in the basement, people are straining to pay their mortgages. According to industry analyst Keith Jurow, "several million" people will have gone nine months without making a payment when the Federal Housing Finance Agency's foreclosure and eviction moratorium expires at the end of the year.
>
> 17% of FHA-insured mortgages were delinquent in July, per the Department of Housing and Urban Development. In NYC, 27.2% of mortgages were.

Another pressing need can be found at state and local governments. Their revenues have withered as the take from taxes and fees has declined. But their need to spend is unabated – they're not enjoying any savings in connection with the slower economy – and in fact it has grown. Police, firefighters and EMTs are no less essential, and the need for health care and family services has only increased. And yet, unlike the federal government, cities and states can't engage in unlimited deficit spending since they can't print money or issue seemingly unlimited amounts of debt. Like companies and individuals, they need significant aid.

On September 24, *The Wall Street Journal* reported on Fed officials' testimony to Congress:

> The recovery would move along faster "if there is support coming both from Congress and from the Fed," Chairman Jerome Powell said during the second of three days of congressional testimony Wednesday.
>
> Chicago Fed President Charles Evans told reporters that his projection that the unemployment rate would fall below 6% by the end of next year had been premised on around $1 trillion in additional fiscal relief.
>
> "If that doesn't happen, then I think it's going to be a lot harder, and much more unlikely that we make that much progress," he said. . . .
>
> **"The power of fiscal policy is really unequaled by anything else,"** Mr. Powell told lawmakers on a House panel overseeing the U.S. response to the coronavirus. (Emphasis added)

The same day, Dennis DeBusschere of Evercore ISI wrote:

> On monetary policy, the Fed is not out of bullets and still has quasi-fiscal programs like the Main Street Lending Program (MLSP) and the Municipal Liquidity Facility (MLF). But as our friends at Macro Policy Partners pointed out, "Powell all but waved the white flag on those programs in his remarks, which is troubling. The Fed has already adopted a 'set it and forget it' stance on rates and QE, and these tools are not as well-suited to the current economic challenges as MSLP and MLF." **So either there is a fiscal package soon and risk assets move higher, or inflation expectations trend lower, forcing the Fed to use more bullets.** Our hunch is the Fed will be forced to react. (Emphasis added)

The economic recovery everyone's counting on is not an independent event, unaffected by developments. Rather, it is highly dependent on progress against the disease, as described above, but also on the continuation of fiscal expenditures in the interim. Sadly, the outlook for action in this latter regard is not good. Partisan enmity is at a level I've never seen before, especially given the fight over the Supreme Court nomination. With the two houses of Congress in the hands of warring parties, I'd be pleasantly surprised if they can agree on anything before the election.

The bipartisan Problem Solvers Caucus in the House restarted the negotiations a couple of weeks ago by surfacing a proposal that would come out in the middle between the Democrats' target of $3 trillion and the Republicans' willingness to spend $500 million, and compromise on the individual components as well. [Note: I'm a national co-chair of No Labels, the organization that supports the caucus and the goal of bipartisan cooperation.] Let's be hopeful that something can be done to appropriate needed aid even while the election campaign is underway.

The Power of Interest Rates

One of the biggest financial stories of 2020 is the powerful market rally that began in late March and quickly caused the equity indices to regain the ground they had lost and in some cases reach new highs. **And the more I think about it, the more credit I attribute to the low level of interest rates.**

As you know, the Fed reduced the fed funds rate – the base rate that influences many other interest rates – by a half-percent on March 3, from 1.50-1.75% to 1.00-1.25%, and by an additional percent on March 15, to 0-0.25%. Low rates like those of today exert influence in a broad variety of ways. I touched on a few of them in my last memo, but I'm going to undertake a fuller treatment of the subject here.

First, there's the stimulative effect of low interest rates. This is probably the aspect people think of first when there's a rate cut. In short, everything that entails financing is made more attractive. It becomes cheaper to buy a house because the monthly mortgage payment is smaller. Ditto for cars and boats. Monthly payments on existing adjustable-rate mortgages decline, leaving consumers more disposable income. Corporate interest expense declines as well, reducing the cost of a new factory or production line. A faster-growing economy improves the general mood and makes transactions more likely. And fear of missing out on the low rates gives people a reason to act now, accelerating transactions that might otherwise have taken place in the future.

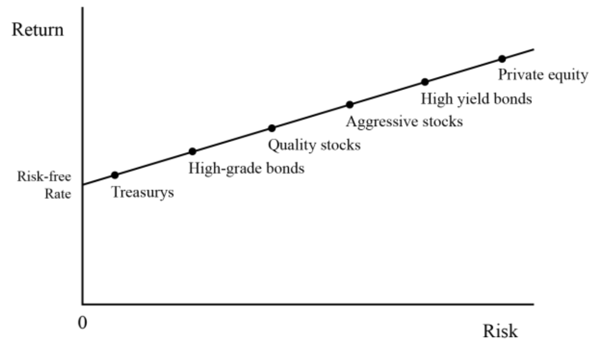
Second, lower rates increase the discounted present value of future cash flows. In the most theoretical sense, the current value of an asset is the discounted present value of the cash flows it will produce in the future. We discount future cash flows because a dollar to be received in the future isn't worth a dollar today: money invested today should bring back more in the future. If you demand a return of 7%, you'll pay $0.51 today for $1 to be received in ten years.

(Discounted cash flow, or "DCF," is widely used to quantify the potential return from investments. The discount rate that sets the estimated future cash flows equal to the initial investment is the return the investment will produce if the flows materialize as expected. Thus, reversing the sentence just above, if you can put up $0.51 today and get back $1 in ten years, the implied return is 7%.)

The rate at which we discount future cash flows depends on the risks involved in waiting for them. These include the risk of actual loss as well as the loss of purchasing power to inflation. If something's risky, we should demand a high return and thus use a high discount rate. However, the rate we use is also a function of prevailing interest rates and the returns available on other investments (opportunity costs). When those things are low, a low discount rate will be used. And the lower the discount rate, the higher the resulting present value. **Thus low interest rates raise the DCF value of all investments.**

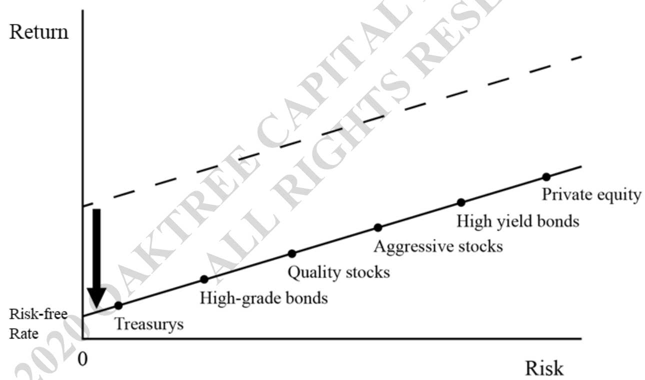
Third, a low risk-free rate brings down demanded returns all along the capital market line. The yield on the 30-day Treasury bill is often referred to as the risk-free rate. There's no credit risk, since the obligor is the government (which can print all the money it needs for repayment), and there's no risk of losing purchasing power to inflation, since repayment at maturity is only days away.

Since the risk-free rate can be earned with complete safety, and most people prefer safety over risk (all else being equal), investors shouldn't take risk without being compensated for doing so. As investments increase in terms of the level of uncertainty, an incremental "risk premium" should be incorporated in their potential returns. Thus the notion of the "capital market line" that slopes upward and to the right, showing the relationship between risk and return, as follows:



In this graphic, the capital market line shows a coherent relationship between expected return and expected risk. When I studied at the University of Chicago business school, they called this "equilibrium": as perceived risk increases, each asset class appears to offer a higher a priori return, such that the prospective risk-adjusted return on each asset is fair relative to the others. **Nothing else makes sense in a market that's functioning well.**

But in March, the Fed lowered the fed funds rate by 1.5%. Predictably, other interest rates, bond yields and prospective returns generally followed suit, as suggested in the next graphic.



The risk/return relationships among asset classes are still reasonable, but all prospective returns are much lower in the absolute. **Thus, in general, the lower the point at which the capital market line originates, the lower all returns will be.**

Or to get away from the graphic and say it in words, when I began to manage high yield bonds in late 1978, the fed funds rate and the yield on the ten-year Treasury note both stood around 9%. As a result, high yield bonds had to offer yields above 12% in order to attract capital (and yet few investors were willing to buy them because of the stigma and because they didn't need yields that high to reach their return goals). But today, with the fed funds rate and yield on the ten-year well below 1%, people are flocking to high yield bonds paying 5-6% like it's free money. The point is that the lower the risk-free rate, the lower the prospective return needed to attract capital to other asset classes.

So the lower the fed funds rate is, the lower bond yields will be, meaning outstanding bonds with higher interest rates will appreciate. And lower yields on bonds means they offer less competition to stocks, so stocks don't have to be cheap to attract buying. They, too, will appreciate. And if high-quality assets become high-priced and thus offer low prospective returns, then low-quality assets will see buying – implying rising prices and falling prospective returns – because they look cheap relative to high-quality assets.

Most decisions in investing are relative decisions. Investors try to find the most attractive opportunity so as to be able to achieve the highest risk-adjusted return. Thus a great deal of the selection process is comparative. "I'm considering buying X. How does its risk/return proposition compare with the one on Y?" That means the lower the return is on Y, the less X has to offer to be the superior investment. And if X is to offer less return, the way it gets that way is through an increase in its price. **Thus, assets and asset classes are inherently interconnected. Money moves from one asset class to the next in search of the best bargains, which get bought up until they're at equilibrium with everything else. Changing the risk-free rate has the potential to reset the returns on everything.**

Fourth, lower demanded returns lead directly to higher valuations. When Treasury notes yield a more normal 3%, investors might demand a return of, say, 6½% (incorporating an "equity premium" of 350 basis points) if they're to invest in the S&P 500 instead of Treasurys. The S&P offers such an "earnings yield" when its earnings represent 6½% of its price, which written as a fraction is 6½/100. The ratio of earnings to price is obviously the inverse of the ratio of price to earnings, or the p/e ratio. An earnings yield of 6½/100 equates to a p/e ratio of 100/6½, or 15.4, which is a rough approximation of the S&P's average p/e ratio since World War II.

Now let's assume a Treasury yield like today's 1%. To offer the same 350 basis point equity risk premium, the earnings yield only has to be 4½%. And an earnings yield of 4½/100 implies a p/e ratio of 22.2. So, in theory, assuming S&P earnings are unchanged, a reduction of the required earnings yield from to 6½% to 4½% calls for an increase in the p/e ratio, and thus in the price, of 44%. This is another way to describe the impact of lower interest rates on asset prices. Lower rates mean higher prices for stocks, just as they do for bonds. (Note: since companies' earnings generally grow while bonds' interest coupons don't, it can be argued that required return on stocks should be even lower, meaning p/e ratios can be even higher.)

Fifth, the Fed also has the ability to lower yields by buying bonds. This is really an extension of the point just above. In addition to lowering the fed funds rate, the Fed can goose the markets by buying Treasury bonds and notes and other types of securities. If the Fed buys securities, that lifts the prices of those securities. When their prices go up, their expected yield to maturity goes down. And when the yield on bonds goes down, other assets can attract capital without offering as much prospective return as they used to, so their prices can rise, too.

Further, when the Fed buys securities, it puts money into the hands of the people who sell them to the Fed, and that money will be spent or loaned (helping the economy) or reinvested (driving up asset prices). In the four months from mid-March to mid-July of this year, the Fed bought mostly Treasury bonds and notes, but also other securities, to the tune of more than $2.3 trillion. That was roughly 20 times what it bought in 18 months during the Global Financial Crisis.

Sixth, low interest rates and the resultant low prospective returns encourage risk tolerance and reaching for return. When a lower risk-free rate pulls down the capital market line as shown above, most assets promise less return than they used to. That means people who in the past got the return they want or need from an asset with a given level of risk now have to move out the risk curve to riskier assets in order to try for that same return.

Today, many U.S. institutional investors are saddled with target returns (in the case of endowments) or actuarial assumptions for return (for defined-benefit pension funds) in the area of 7%, give or take. Unfortunately, these needed returns have not come down nearly as much as interest rates (and thus prospective investment returns) have fallen. For return targets to decline as much as interest rates, universities and charities would have to be content with receiving reduced support from their endowments, and pension plan sponsors would have to come up with increased funding.

The investments one might have made in the past now promise far less return than they used to. With prospective returns on cash near zero, the ten-year Treasury at 0.7%, high grade bonds yielding 2-3% and stocks expected to return 5-6%, what's an investor needing 7% to do? The usual answer is to take on more risk in pursuit of the higher returns that riskier investments appear to promise.

In this way, low rates make risk aversion a challenging thing to practice and risk taking much more palatable. The alternative is to accept today's lower promised returns. But most people opt for the former, and that means risky asset classes become crowded with eager capital, something that's not beneficial for risk-adjusted returns. Bad things tend to happen when FOMO – the fear of missing out – takes over from risk aversion, or the fear of losing money.

Seventh, the need to put money to work causes the capital markets to reopen. In most financial crises, the "credit window" slams shut because people with capital (a) are nursing losses on the assets they own and (b) are terrified about the future of the environment. Those two factors make them reluctant to provide new financing, and that in turn means capital is unavailable – even to deserving companies and potentially lucrative projects. That, in turn, means risk assets decline in price, causing prospective risk-adjusted returns to rise.

But today, the Fed and Treasury have reassured investors that they will ride to the rescue, that large amounts will be made available to companies and other participants in the economy, and that they can depend on a prompt recovery. This has enabled investors to "look across the valley" to better times. This in turn has enabled low rates to coerce sources of capital to provide generous levels of financing.

Thus, today, credit is liberally available, and bond issuance has equaled or eclipsed many prior records. For example, despite the biggest quarterly decline in GDP in recorded history and the closure of the capital markets for a while, $345.6 billion of U.S. high yield bonds have been issued so far this year, according to S&P. That's more than the record $344.8 billion issued in all of 2012.

In all these ways, a low risk-free rate makes even low investment returns seem attractive. **Thus, today, it seems to me that most assets are offering expected returns that are fair relative to their expected risk, relative to everything else. But the prospective returns on everything are about the lowest they've ever been.**

<u>Changes in the Composition of the Stock Market</u>

In *Time for Thinking*, I also mentioned the increased bifurcation of the U.S. equity market. In short, the leading tech and software companies (a) have become more different from other companies as the role and power of technology have expanded and (b) have become a much larger part of equity indices as such companies have grown and become more highly valued, and as indices like the S&P 500 have changed their composition to remain relevant. While I'm no expert, I'm going to cite a few of the arguments regarding the significance and implications of this trend. (Thus I pass on these appealing arguments; I don't endorse them).

First, the attributes and returns on the two groups of stocks have become more differentiated.

- The gap between the growth outlook for FAAMG (Facebook, Apple, Amazon, Microsoft and Google) and similar companies and that for the rest (in the slow-growing 21st century) is huge and expanding.
- The adoption of technology has been pulled forward by the pandemic. Thus virtual meetings, ecommerce and cloud computing are now commonplace, not the exception.
- Current profits severely understate the tech leaders' potential. They currently choose to spend aggressively on new product development to expand share and head off competition, voluntarily suppressing profit margins. Thus enormous potential exists for the tech companies to increase profit margins in the future when they become willing to moderate their growth rates.
- Their addressable markets are larger than ever and growing, giving them greater "runway." For example, at the end of 1999, during the tech bubble, there were 248 million Internet users in the world. Now there are more than that in the U.S. alone and almost 5 billion worldwide. Thus 62% of the world's population carries a computer with Internet connectivity in his or her pocket.
- Finally, it's easier than ever to scale these businesses. In the past, one would have to go to a dealer to buy software on a disc, take it home and install it. Now we download apps from the web in seconds.

For these reasons, a large differential in terms of p/e ratios is warranted.

Second, these groups will not merely coexist and perform differently. Rather, the tech companies have the potential to negatively impact some of the non-tech companies. The common term for this phenomenon is "disruption." Amazon has endangered brick-and-mortar retailers. Netflix has challenged the traditional TV and movie ecosystem. Facebook has cut into newspapers and other traditional media – industries thought to be protected by moats and thus "defensive." Tesla has revolutionized the auto industry and outperformed the incumbents in developing electric vehicles. The list of industries immune to technological change – in terms of profitability if not their essential nature – is limited.

Finally, it's argued that the leading tech companies of today are stronger than the Nifty Fifty of the late 1960s. Today's leaders are often compared to the Nifty Fifty, but they're much better companies: larger; faster growing with greater potential for prolonging that growth; capable of higher gross margins (since in many cases there's no physical cost of production); more dominant in their respective markets (because of scale, greater technological superiority and "lock in," or impediments to switching solutions); more able to grow without incremental investment (since they don't require much in the way of factories or working capital to make their products); and possibly valued lower as a multiple of future profits. This argues for a bigger valuation gap and is perhaps the most provocative element in the pro-tech argument.

Of course, many of the Nifty Fifty didn't prove to be as powerful as had been thought. Xerox and IBM lost the lead in their markets and experienced financial difficulty; the markets for the products of Kodak and Polaroid disappeared, and they went bankrupt; AIG required a government bailout to avoid bankruptcy; and who's heard from Simplicity Pattern lately? Today's tech leaders appear much more powerful and unassailable.

But fifty years ago, the Nifty Fifty appeared impregnable too; people were simply wrong. If you invested in them in 1968, when I first arrived at First National City Bank for a summer job in the investment research department, and held them for five years, you lost almost all your money. The market fell in half in the early 1970s, and the Nifty Fifty declined much more. Why? Because investors hadn't been sufficiently price-conscious. In fact, in the opinion of the banks (which did much of the institutional investing in those days) they were such good companies that there was "no price too high." **Those last four words are, in my opinion, the essential component in – and the hallmark of – all bubbles.** To some extent, we might be seeing them in action today. Certainly no one's valuing FAAMG on current income or intrinsic value, and perhaps not on an estimate of e.p.s. in any future year, but rather on their potential for growth and increased profitability in the far-off future.

And note that a lot of the strength and potential of today's tech leaders derives from their dominant market shares and market power. This same element creates one of their greatest vulnerabilities: potential exposure to anti-trust action. Bigness and the successful tactics that led to it are enough to make some people call for constraints on the incumbents. Here's what Barclays reported on October 7:

> Yesterday, US large-cap technology stocks (i.e. Facebook, Amazon, Google and Apple) came under pressure after the House antitrust subcommittee released a 449-page report proposing far-reaching antitrust reforms. Recommendations include structural separation, prohibiting a dominant platform from operating in competition with the firms dependent on it and line-of-business restrictions, limiting the markets in which a dominant firm can engage.

There are two groups of stocks in the indices, and the representation of tech stocks is large and expanding. In the S&P 500, for example, roughly one-quarter by value consists of tech and software companies that are fast growing and have the ability to increase both revenues and profit margins, and the remaining three-quarters is slow growing and already enjoying maximum margins. Today's tech leaders are more superior than ever to run-of-the-mill companies, rendering indices that include both types of company less relevant than ever. Or so it's argued. Regardless of where you come out on that question, if an index consists 25% of great growth companies at high multiples (up roughly 30% this year as of the end of September) and 75% more pedestrian companies at low multiples (up 4%), **the average figures in terms of growth, valuation and performance might not be meaningful enough to support conclusions about "the stock market."**

<u>A Different Kind of Crisis</u>

One question I'm often asked nowadays is how the coronavirus crisis of 2020 differs from the past crises we've managed through:

- the high yield bond crisis of 1990-91, when many prominent LBOs of the '80s went bankrupt,
- the telecom/scandal company meltdown in 2001-02, and
- the Global Financial Crisis of 2008-09, brought on by the implosion of sub-prime mortgages and marked by the meltdown of financial institutions.

The clear difference I want to cover here relates to the characteristics of the current go-round. The best way to start might be to describe the crises of the past:

- In each of the three crises listed above, recessions caused or exacerbated economic weakness.

- Negative economic and corporate developments, collapsing markets and rising fear caused a credit crunch in which financing became impossible to obtain.
- The combination of economic weakness and the unavailability of financing led to vastly increased defaults and bankruptcies.
- Asset prices cratered.
- Companies and investment entities marked by asset/liability mismatches and/or high levels of leverage experienced margin calls and meltdowns.
- The downward spiral seemed unstoppable.
- Pessimism ran rampant, leading to soaring risk aversion.
- This led to panic selling of assets and rendered most investors absolutely unwilling to buy.
- Because of all the above, it was possible to purchase assets at prices from which extremely high returns could be achieved, often with low attendant risk.

Now, contrast that with the events of 2020. In mid-February, developments regarding the coronavirus pandemic and the lockdown implemented to fight it began to hammer the markets. Prices for equities and credit fell, and the mood turned darkly negative. From the all-time high reached on February 19, the S&P 500 fell 34% in only 33 days. The prices of high yield bonds and leveraged loans were hard-hit as well. Security issuance stopped cold. The pieces were in place for a crisis just like those described above, and things were moving in that direction in March.

But as everyone knows, the Treasury and Fed announced rescue programs in mid-March and an enlarged Fed program during the week of March 23: zero interest rates, bond buying, grants, loans and significantly enhanced unemployment payments. The total ran to multiple trillions of dollars. And the authorities made it clear that there was more behind that: that the available resources were unlimited.

- People accepted that the recession would end and a recovery take its place in short order.
- With short-term interest rates near zero, investors lined up to buy bonds in the quest for return. Thus rather than a credit crunch, there's been record amounts of capital available.
- Even though the rescue provided "liquidity but not solvency," whole industries (like the airlines) were saved from sure bankruptcy.
- There were none of the spectacular implosions that mark most crises.
- Ditto for panic selling.
- Pessimism was replaced by willingness to think about better times ahead.
- With interest rates at zero, investors couldn't afford to be risk averse. They had to embrace risk assets in order to have a shot at returns above the low single digits.
- Thus asset prices recovered.

To illustrate the effect, since April 1, investors in distressed debt have had opportunities to make large rescue loans to companies or entities needing a quick response to problems related to illiquidity or pending debt maturities, and there's still a good pipeline. But with investor optimism reinforced, competition to lend has increased, and the ultra-low returns available on safe assets have made the possibility of double-digit returns something people compete to achieve. The sum of all this has kept prospective returns far lower than is usual in times of crisis.

Thus this is an unusual crisis: one marked by a non-financial, exogenous cause and a lack of lasting pain for most investors . . . and not by widespread opportunities for bargain hunters. Great investments are often made when an investor is willing to buy something no one else will touch at any price. We were able to do just that in past crises, because what you needed was money to spend and the nerve to spend it, and we had those things when most didn't. **Other investors' lack of money and nerve in past crises made them great times for buying. Today, thanks to the Fed and Treasury, everyone's got a lot of both. That makes things much tougher.**

But what happens if people exhaust the support payments they've received, Washington fails to deliver sufficient additional assistance, widespread layoffs ensue (as seems to be beginning) and business slows again? Mightn't we see a rise in defaults and bankruptcies and a softening of investor psychology and thus asset prices?

The Potential Downside of the Rescue

Along with the sweep of the Covid-19 epidemic and the magnitude of the recession that resulted from combatting it, the size and success of the Fed/Treasury rescue effort is one of the big stories of 2020. In the Global Financial Crisis, it took the authorities months to figure out what to do and do it. But this year, they dusted off the 2008 playbook and implemented it in a couple of weeks.

We've never seen an economic environment like the one brought on by the lockdown. Many industries (plus other entities and institutions) with zero activity and no revenues, but still high costs. And millions of people without jobs or incomes. There's a belief (never documented) that a large part of the American population lacks resources with which to survive a $400 emergency. How would they survive months without paychecks? Without paychecks, how would they patronize merchants? Without making sales, how would merchants pay their rent? Or their taxes? Without rental income, how would property owners service their debt? Without income from debt service, how would lenders stay solvent? Without tax revenues, how would state and local governments pay their employees and continue to provide services? And how would developed nations purchase the exports that emerging economies need to make to survive? The picture we faced in mid-March was truly the worst I've seen. Global depression seemed possible.

But the Fed and Treasury brought their massive concerted effort, simulating the activity of the economy and replacing a good bit of the lost cash flows. It succeeded to a startling degree. Most investment markets recovered, and the economy has shown surprising strength. Thus the next thing I want to discuss are the possible ramifications of the rescue. I've touched on this before, but it's one more thing on which I want to go into greater depth.

First, what are the policy implications of zero rates? To me, the most obvious one is that there's no more room to cut. (Fed officials insist they won't take rates into negative territory, and negative rates certainly can't be said to have rekindled economic growth in Japan and Europe.) Thus the question is how the Fed would counter an economic relapse connected with something like a second wave of Covid-19 and resultant second lockdown.

Second, rescues and bailouts have the potential to cause moral hazard. When the government saves people from losses, it teaches that it's okay to make risky investments: if they work out, you get rich; if they don't work, you'll be bailed out. That's a bad lesson. This year, for example, lifelines have been thrown to industries that over-borrowed, over-expanded and/or spent too much of their cash on stock-buybacks. Yet it was decided that they wouldn't be permitted to go bankrupt.

Further, by dramatically lifting the markets, the Fed may have caused some people to believe that it will always do so – that there's a "Powell put" that can be counted on to keep things humming. (Think back to the tantrum the stock market threw in the fourth quarter of 2018, when the yield on the ten-year Treasury got up to 3.25%. It was enough to end the program of interest rate increases that Janet Yellen had initiated and bring on a series of cuts instead.) If investors believe the Fed can always be counted on to keep the markets aloft, that will encourage dangerous behavior. And, anyway, it seems like an impossible task and, in my opinion, a questionable goal for the Fed.

Third, the kneejerk reaction to trillions of dollars of deficit spending on the part of the Treasury and further trillions of dollars of bond buying by the Fed is worry about inflation. The injection into the economy of trillions in added liquidity would seem to have the potential to create too much money chasing too little in the way of goods, causing prices to rise (as it has done for assets). Further, as a result of the rescue measures, we're running a multi-trillion-dollar deficit and adding trillions to the national debt, which as a percentage of GDP now approaches the high established after World War II.

Printing large amounts of money has had severe consequences in the past. One wonders whether the 2020 version might bring about some of the things traditionally associated with currency debasement:

- undesirably high inflation,
- weakness of the U.S. dollar,
- a downgrade of the U.S. credit rating,
- an increase in the cost of borrowing to cover the increased deficit,
- rising interest rates generally, adding further to the cost of debt service, and thus to the deficit and debt,
- the allocation of an increasing share of the federal budget to debt service, and
- the dollar's loss of status as the world's reserve currency.

Of course, there are rejoinders:

- We've been engaged in deficit spending for a long time without any rekindling of inflation or other ill effects. (Of course, this can be likened to the frog sitting in the pot of water that's being heated. It doesn't notice the gradually rising temperature until it's too late.)
- Nations have been trying to create 2% inflation for years without success. Thus (a) inflation isn't easily ignited and (b) inflation isn't the problem – the lack of it is.
- Modern Monetary Theory says (over-simplifying) that deficits and debts don't matter. (But most economists disagree, and common sense suggests it's unlikely a country can spend beyond its means to an unlimited degree without repercussions.)
- Finally, there's no obvious candidate to replace the dollar as the reserve currency.

All I know is that (a) the Fed and Treasury seem unworried about the possibility of any of the above and (b) anyway, they consider continuing the program indispensable.

Fourth, what the Fed does worry about is anemic growth. It will certainly take a fair while – a year or more following the low reached in the second quarter of this year – for GDP to regain the level achieved in 2019 and what it was supposed to be in 2020. A stagnant economy would fail to put people back to work who lost their jobs as a result of the lockdown, and it certainly wouldn't provide jobs for a growing population.

> "The risk here is a downward spiral," [Lael Brainard, a Fed governor, noted in a recent speech], warning that the economy could be trapped in a vicious cycle of low interest rates, muted inflation and weak growth.
>
> Long-term trends such as disappointing productivity gains and limited labor force growth are sapping the economy's potential. In July, the Congressional Budget Office said the U.S. economy could expand in the long run at an average annual rate of just 1.8 percent — down from more than 4 percent in 2000. (*The Washington Post*, October 3)

Because this is the Fed's prime concern, it's less worried about the risks entailed in its efforts to rescue and stimulate the economy as described above. It is perfectly willing to see inflation at 2%, something that it hasn't been for years. In fact, it recently announced an averaging approach under which monetary policy will remain loose and rates low until inflation averages 2%. That is to say it will be permitted to run above 2% for a while as a way to bring the average up to 2%.

Some say the worst of all worlds would be stagflation, which I lived through in the 1970s: high inflation and economic weakness. Certainly it was a dismal decade. But others think economic sluggishness is more likely to lead to disinflation (declining inflation) or even deflation, a phenomenon so rare we know little about it.

> The secular deterioration in economic growth has created a condition of excess resources and disinflation. (*Hoisington Quarterly Review and Outlook*, Third Quarter 2020)

My answer is that I have no idea whether we'll see inflation, stagflation, stagnation, disinflation or deflation, and Oaktree won't bet on any of them. It's one of the tenets of our investment philosophy that our investment decisions aren't driven by macro forecasts. Not that it wouldn't be nice to know what the future holds in these regards; rather it's simply that most investors – and certainly we – aren't capable of superior judgments about the macro. So why bet?

Finally, I want to state clearly that nothing I've written on the subject of the rescue and its possible ramifications is intended to be critical of the Fed and Treasury and their actions. I put it simply: just because something has potential negative consequences doesn't mean you shouldn't do it. In the case of the pandemic and associated recession, there was absolutely no alternative. While not perfect, the policy response has been brilliant.

Further Exposing Inequality

Especially in this environment of heightened attention to social and racial justice, I can't end this memo without touching on some of the many ways in which the recent experience has shed additional light on inequality in our society:

- People further down the economic ladder have had less in terms of financial resources to fall back on during the lockdown, and they generally haven't benefitted from the increase in asset prices that's been driven by the reduction of interest rates.
- Low-income workers have been more likely to lose their jobs due to the lockdown and recession.
- Those who've kept their jobs (often in industries like food production, retail and hospitals) are more likely to be essential workers, required to work and put in harm's way. White-collar and administrative employees, on the other hand, are much more likely to be able to work from home.

- Low-income people are more likely to live in cramped quarters and crowded neighborhoods, giving them a lower quality of life if working from home and an increased chance of contracting the disease.
- For all these reasons, the incidence of Covid-related sickness and death has been disproportionately high among these populations.
- People with lower incomes are more dependent on the schools to help with childcare. Thus school closings have had a greater impact on lower-income families, which are less able to keep kids home when given the choice. Rather they have to send them to school, where they are exposed to contracting the disease and bringing it home to parents and grandparents.
- Finally, women are more exposed to this phenomenon than men: they make up a higher percentage of single parents, their wages may be lower than those of male partners, and they're often expected to be the ones shouldering the responsibility for childcare.

Of course, "lower income" is disproportionately synonymous with "non-white." Taken together, I believe there's been a "tale of two cities." The overall experience of lower-income Americans during the pandemic – and thus of Blacks and Hispanics – has been a far cry from that of whites and those with higher incomes and greater financial resources. These observations are likely to be part of the conversation on equality of opportunity that lies ahead for our country.

What It All Means for the Markets

For years leading up to 2020, I described the investment environment as follows:

- An unusually high level of uncertainty (mostly exogenous and geopolitical)
- The lowest prospective returns ever
- Asset prices that were full to excessive
- Pro-risk behavior being engaged in by investors trying for high returns

Taken together, these things told me we were living in a low-return world in which the promised returns didn't fully compensate for the risks. It wasn't a bubble, characterized by absurdly high prices. And there was no way to say for sure when the good times would end or why. It was merely the absence of justification for taking full risk.

Thus Oaktree operated under the mantra "Move forward, but with caution." We invested, and we tried to be fully invested. But we endeavored to do so "with caution." And since we always take a cautious approach to our risk-asset strategies, it really meant "more caution than usual." Being fully invested in a cautious portfolio caused us to lag the benchmarks a bit in some of the asset classes where we have them, as it turned out that caution generally wasn't needed – until this year.

Our cautious stance was rewarded in the difficult first quarter of 2020. **The conditions I described above made the markets vulnerable to exogenous shock, and we got a doozy.** Importantly, that caution enabled us to approach our portfolios calmly, generally unconcerned about price declines and not burdened with widespread problems requiring remediation. In drawdown funds with capital available, we were able to act affirmatively, picking up bargains when their availability peaked in March.

Now, however, I think we've returned to the market conditions I used to go on about.

- The same uncertainties exist as were present last year (except that the recession and ending of the bull market that were considered ultimately inevitable have come and gone). In addition, we have some new uncertainties. The full list includes the battle against Covid-19, the shape of the recovery, the implications of the election and whether it will go smoothly, worry about higher taxes and more redistribution, the divisiveness in our country, and the outlook for racial harmony.
- If prospective returns were low in the last few years, they're even lower today thanks to the reduction of interest rates. A near-zero return on cash, 2% on investment grade debt, 5% on high yield bonds, 5-6% expected from equities – at the same time as lots of capital is eager to be put to work. Adequate returns are likely to be hard to come by.
- The stock market is back near the high reached in February and selling at an above average valuation (as described earlier). The only things that appear to be low-priced are the ones that appear fundamentally most risky, such as oil & gas, retailers and retail real estate, office buildings and hotels, and low-rated tranches of structured credit. As I said earlier, everything appears to be fairly priced relative to everything else, but nothing is cheap thanks to the low base interest rate.
- Thus, after a brief foray into bargain-land in March, we're back to a low-return world. But since most investors haven't reduced their required or targeted returns, they have to engage in elevated risk in order to pursue them.

In my view, the low interest rates represent the dominant characteristic of the current financial environment, creating the dominant consideration for investors: the lowest prospective returns in history (for the reasons described on pages 4-6). Thus I've dusted off a presentation I've been giving in recent years called "Investing in a Low-Return World." At its end, after laying out much of the above, I conclude by enumerating the strategic alternatives for investors:

- **Invest as you always have and expect your historic returns.** Actually, this one's a red herring. The things you used to own are now priced to provide much lower returns.
- **Invest as you always have and settle for today's low returns.** This one's realistic, although not that exciting a prospect.
- **Reduce risk in deference to the high level of uncertainty and accept even-lower returns.** That makes sense, but then your returns will be lower still.
- **Go to cash at a near-zero return and wait for a better environment.** I'd argue against this one. Going to cash is extreme and certainly not called for now. And you'd have a return of roughly zero while you wait for the correction. Most institutions can't do that.
- **Increase risk in pursuit of higher returns.** This one is "supposed" to work, but it's no sure thing, especially when so many investors are trying the same thing. The high level of uncertainty tells me this isn't the time for aggressiveness, since the low absolute prospective returns don't appear likely to compensate.
- **Put more into special niches and special investment managers.** In other words, move into alternative, private and "alpha" markets where there might be more potential for bargains. But doing so introduces illiquidity and manager risk. It's certainly not a free lunch.

None of these alternatives is completely satisfactory and free from downside. But in my view there are no others.

To put it into the terms I've been using over the last several years, how should the balance be set today between aggressiveness and defensiveness? How should you "calibrate" the riskiness of your portfolio? Should it be at your normal level; titled toward offense to try to wrest high returns from a low-return world; or tilted toward defense in deference to the uncertainties, requiring you to settle for lower returns?

As I'm sure is my bias, I lean toward defense at this time. In my view, when uncertainty is high, asset prices should be low, creating high prospective returns that are compensatory. But because the Fed has set rates so low, returns are just the opposite. **Thus the odds aren't on the investor's side, and the market is vulnerable to negative surprises. This is how I described the prior years, and I'm back to saying it again.** The case isn't extreme – prices aren't grievously high (assuming interest rates stay low, which they're likely to do for several years). But it's hard in this context to find anything mouth-watering.

October 13, 2020

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Memo to: Oaktree Clients

From: Howard Marks

Re: Something of Value

If asked about possible silver linings to this pandemic, I would list first the chance to spend more time with family. Our son Andrew and his wife and son moved in with Nancy and me in Los Angeles at the beginning of the pandemic, as they were renovating their house when Covid-19 hit, and we lived together for the next ten weeks. There's nothing like getting to spend months at a time building relationships with grandchildren, something we were privileged to do in 2020. I'm sure the impact will literally last lifetimes.

As I've previously reported, Andrew is a professional investor who focuses on making long-term investments in what the world calls "growth companies," and especially technology companies. He's had a great 2020, and it's hard to argue with success. Our living together led me to talk with him and think a great deal about subjects on which I hadn't previously spent much time, contributing a lot to what I'll cover in this memo.

*   *   *

I've written before about how the questions I'm asked give me a good sense for what's really on people's minds. These days, one I frequently field is about the outlook for "value" investing. "Growth" stocks have meaningfully outperformed "value" for the last 13 years – so long that people are asking me whether it's going to be a permanent condition. My extensive discussions with Andrew led me to conclude that the focus on value versus growth doesn't serve investors well in the fast-changing world in which we live. I'll start by describing value investing and how investors might think about value in 2021.

<u>What is Value Investing?</u>

Value investing is one of the key disciplines in the world of investing. It consists of quantifying what something is worth intrinsically, based primarily on its fundamental, cash flow-generating capabilities, and buying it if its price represents a meaningful discount from that value. Cash flows are estimated as far into the future as possible and discounted back to their present value using a discount rate made up of the prevailing risk-free rate (usually the yield on U.S. Treasurys) plus a premium to compensate for their uncertain nature. There are a lot of common valuation metrics, like the ratio of price to sales, or to earnings, but they're largely subsumed by the discounted cash flow, or DCF, method.

Now, determining this value in practice is quite challenging, and the key to success lies not in the ability to perform a mathematical calculation, but rather in making superior judgments regarding the relevant inputs. Simply put, the DCF method is the main tool of all value investors in their effort to make investment decisions based on companies' long-term fundamentals.

Importantly, value investors recognize that the securities they buy are not just pieces of paper, but rather ownership stakes in (or, in the case of credit, claims on) actual businesses. These financial instruments have a fundamental worth, and it can be quite different from the price quoted in the market, which is based on the manic-depressive ups and downs of a character Benjamin Graham called "Mr. Market." On any given day, Mr. Market can be exuberant or despondent, and he quotes prices for securities based on how he feels. The value investor understands that – rather than informing us as to what a given asset's value is – Mr. Market is there to serve us by offering up securities at prices, which can be meaningfully disconnected from the actual value of a stake or claim in the underlying business. In doing so, he sometimes gives us the opportunity to snatch up shares or bonds at a meaningful discount from their intrinsic value. This activity requires independent thought and a temperament that resists the emotional pull of the market cycle, making for decisions based solely on value.

Thus, to me the essential underlying principles of value investing are these:

- the understanding of securities as stakes in actual businesses,
- the focus on true worth as opposed to price,
- the use of fundamentals to calculate intrinsic value,
- the recognition that attractive investments come when there is a wide divergence between the price at which something is offered in the market and the actual fundamental worth you've determined, and
- the emotional discipline to act when such an opportunity is presented and not otherwise.

Value vs. Growth

Over the last 80-90 years, two important developments occurred with regard to investing style. The first was the establishment of value investing, as described above. Next came "growth investing," targeting a new breed of companies that were expected to grow rapidly and were accorded high valuation metrics in recognition of their exceptional long-term potential.

It seems likely that the label "value" was applied to the value school because one of its greatest early popularizers, Ben Graham, practiced a low-valuation style. Deemed "cigar butt" investing by his protégé Warren Buffett, Graham's style emphasized the search for pedestrian companies whose shares were selling at discounts from liquidation value based on the assets on their balance sheets, which Buffett likened to searching the street for used cigar butts that had one last puff left in them. It is this style that Graham preached in his Columbia Business School classes and his books, *Security Analysis* and *The Intelligent Investor*, which are considered the bibles of value investing. His investment style relied on fixed formulas to arrive at measures of statistical cheapness. Graham went on to achieve enviable investment performance although, funnily enough, he would later admit that he earned more on one long-term investment in a growth company, GEICO, than in all his other investments *combined*.

Buffett, the patron saint of value investors, also practiced cigar butt investing with great success in the first decades of his career, until his partner, Charlie Munger, convinced him to broaden his definition of "value" and shift his focus to "great businesses at fair prices," in particular because doing so would enable him to deploy much more capital at high returns. This led Buffett to invest in growing companies – such as Coca-Cola, GEICO and the Washington Post – that he could purchase at valuations that were not particularly low in the absolute, but that he found attractive given his understanding of their competitive advantages and future earnings potential. While Buffett has long understood that a company's prospects are an enormous component of its value, his general avoidance of technology stocks throughout his career may have unintentionally caused most value investors to boycott those stocks. Intriguingly, Buffett allows that his recent investment in Apple has been one of his most successful.

Over time, a subset of value investors adopted a harder-line approach, with a pronounced emphasis on low valuation metrics. Graham and Buffett's cigar butts had featured low valuation metrics, and this no doubt caused some value investors to elevate this characteristic to be the core consideration in their investment process. It's interesting to note that the methodology for populating the S&P 500 Value Index relies solely on finding the one-third of the S&P 500's market capitalization with the highest ratio of Value Rank (based on the lowest average multiple of earnings, sales and book value) to Growth Rank (based on the highest three-year growth in sales and earnings and 12-month price change). In other words, the stocks in the Value Index are those that are most characterized by "low-valuation parameters" and least characterized by "growth." **But "carrying low valuation parameters" is far from synonymous with "underpriced."** It's easy to be seduced by the former, but a stock with a low p/e ratio, for example, is likely to be a bargain only if its current earnings and recent earnings growth are indicative of the future. Just pursuing low valuation metrics can lead you to so-called "value traps": things that look cheap on the numbers but aren't, because they have operating weaknesses or because the sales and earnings creating those valuations can't be replicated in the future.

The growth investing camp, on the other hand, came into existence during the "go-go" early years of the 1960s, the decade in which I started my career in the equity research department at First National City Bank. Investor interest in rapid growth led to anointment of the so-called Nifty Fifty stocks, which became the investment focus of many of the money-center banks (including my employer), which were the leading institutional investors of the day. This group comprised the fifty companies believed to be the best and fastest-growing in America: companies that were considered so good that "nothing bad could happen to them" and "there was no price too high" for their shares. Like the objects of most manias, the Nifty Fifty stocks showed phenomenal performance for years as the companies' earnings grew and their valuations rose to nosebleed levels, before declining precipitously between 1972 and 1974. Thanks to that crash, they showed negative holding-period returns for many years. Their dismal performance cost me my job as director of equity research (and led to my being assigned to start funds for investment in high yield and convertible bonds – my lucky break). It's worth noting, however, that the truly durable growth companies among the Nifty Fifty – about half of them – compiled respectable returns for 25 years, even when measured from their pre-crash highs, suggesting that very high valuations can be fundamentally justified in the long term for the rare breed of company.

The two approaches – value and growth – have divided the investment world for the last fifty years. They've become not only schools of investing thought, but also labels used to differentiate products, managers and organizations. Based on this distinction, a persistent scoreboard is maintained measuring the performance of one camp against the other. Today it shows that the performance of value investing lagged that of growth investing over the past decade-plus (and massively so in 2020), leading some to declare value investing permanently dead while others assert that its great resurgence is just around the corner. My belief, especially after some deep reflection over the past year – prompted by my conversations with Andrew – is that **the two should never have been viewed as mutually exclusive to begin with**. We'll get to that shortly.

<u>Vantage Points</u>

An interesting aspect of my discussions with Andrew has been our joint recognition of the fact that we come from very different backgrounds, and perhaps for that reason we look at investing from considerably different vantage points.

I began to form my investment philosophy in the 1960s. Investment thought was much less developed at that time, and what did exist was heavily dominated by the philosophy espoused by Ben Graham. Buffett was still searching for his last puff of "cigar butts" and had yet to coin the term "moat" in reference to the lasting competitive advantages that sustain high-quality businesses. My philosophy was informed by the fact that I started working in 1969, during the "Nifty Fifty" bubble, which I watched crash around me.

It was further shaped by my transition in 1978 from equities to fixed income investments in the form of convertible and high yield bonds. Importantly, Graham and his less famous co-author, David Dodd, characterized bond management as a "negative art." What did they mean? In general, bond investors' return is capped at a yield that stems from the promised interest payments and payoff at par upon maturity; that's why it's called "fixed income." The upshot is that all bonds bought at a 6% yield will return 6% when held to maturity if they pay. Bonds that don't pay, on the other hand, will produce losses of varying magnitudes. Thus, oversimplifying, you improve your performance in bonds not through which paying bonds you buy (since all 6% bonds that pay will have the same return), but through what you exclude (that is, whether you're able to avoid the ones that don't pay). Clearly, this is very different from equities, where your upside is theoretically unlimited, requiring that investors intelligently balance downside risk and upside potential.

To be a good equity investor, I think you have to be an optimist; certainly, it's no activity for doomsayers. On the other hand, the term "optimistic bond investor" is practically an oxymoron. Since bonds generally lack potential for long-term returns in excess of their promised yields, bond investing mostly requires skepticism and attention to the downside. One of the reasons I did well in fixed income is that it played to my natural conservatism. And since tech companies issue relatively few bonds, it also accommodated my lack of focus on technology, which has never been of particular interest to me and has always felt a bit "over my head." I'm certainly not an "early adopter," nor do I have a history of recognizing emerging technological trends in their infancy.

Lastly, as a child of parents who were born in the early 1900s and thus were adults during the Great Depression, my thought process was shaped by the deprivation and fear they had experienced. Because they had been made so painfully aware of the value of a dollar and how quickly things could change for the worse, they considered the future and the possibility of loss things to worry about. Adages like "don't put all your eggs in one basket" and "save for a rainy day" were watchwords I grew up with. This is very different from the experience of those whose parents were born a decade or two later than mine, never lived with deprivation, and may never have heard those words. These influences and experiences led me to adopt a value approach and the persona of a "bargain hunter," which has served me well in my chosen field, which now has come to be called "credit."

Andrew has a considerably different mindset. Clearly, his early experience was very different from mine, not marked by anything like the Depression. He was bitten by the investment bug early, and from a young age investing dominated our conversations. While he deeply appreciates some elements of my philosophy – such as the importance of understanding investor psychology, focusing on fundamentals, and contrarianism – he has forged his own path and ended up in a very different place. His first phase was spent as a "Buffett nerd," consuming everything written by the Oracle and adhering strongly to his philosophy. But over time, he has developed his own perspective and transitioned to investing primarily in technology and other growth-oriented companies. He spends the vast majority of his time managing a venture firm called TQ Ventures with his two partners, but he also steers our family's "upside-oriented investments" with great results. (I, fittingly, handle our more conservative investments).

This contrast of viewpoints, particularly in 2020, has created extraordinary opportunities for discussion and learning. **From this point on, most of what I write will consist of what Andrew has caused me to appreciate in my 75th year.**

The False Dichotomy of Value and Growth

At some point, the camps of value and growth developed nearly the same fervent adherence as rival political factions. You pledged allegiance to one or the other, and so went your future investing actions. You believed your way was the only way and looked down on practitioners of the other. I think investors – perhaps based on their emotional makeup, intellectual orientation and understanding of things like technological innovation – naturally gravitated toward one side of the stylistic divide or the other. And there are notable differences:

- Value stocks, anchored by today's cash flows and asset values, should *theoretically* be "safer" and more protected, albeit less likely to earn the great returns delivered by companies that aspire to rapidly grow sales and earnings into the distant future.
- Growth investing often entails belief in unproven business models that can suffer serious setbacks from time to time, requiring investors to have deep conviction so as to be able to hang on.
- When they're rising, growth stocks typically incorporate a level of optimism that can evaporate during corrections, testing even the most steeled investor. And because growth stocks depend for most of their value on cash flows in the distant future that are heavily discounted in a DCF analysis, a given change in interest rates can have meaningfully greater impact on their valuations than it will on companies whose value comes mainly from near-term cash flows.

Despite these points, I don't believe the famous value investors who so influenced the field intended for there to be such a sharp delineation between value investing, with its focus on the present day, low price and predictability, and growth investing, with its emphasis on rapidly growing companies, even when selling at high valuations. Nor is the distinction essential, natural or helpful, especially in the complex world in which we find ourselves today. Both Graham and Buffett achieved success across a variety of styles and, more importantly, viewed value investing as consisting of adherence to fundamental business analysis, divorced from the study of market price action. As Buffett put it, "We don't consider ourselves to be value investors. . . . Discounted cash proceeds is the appropriate way to value any business. . . . There is no such thing in our minds as value and growth investing." It just so happened that considerable opportunity existed for them in the cigar butt arena at the time they operated – especially considering that both started with relatively small amounts of money with which to invest – so that's what they emphasized. But as the world evolved, the landscape of opportunities has changed significantly.

There's a saying that "to the man with a hammer, everything looks like a nail." The widely discussed distinction between value and growth made some people believe they only had hammers, when in fact they potentially had access to a whole toolbox. **Now we live in a complex world where a range of tools is required for success.**

A More Efficient World

As mentioned earlier, the investment world back when Buffett and Graham were first practicing their version of value investing was considerably different from the current one. First, the level of competition was much lower, almost unrecognizable when compared to today. Investment management wasn't a hot field in which many people aspired to spend their careers. It was instead a cottage industry, with a small number of outfits practicing quite traditional activities. Second, information was extremely hard to come by and process. There were no computers, spreadsheets or databases. Before researching a stock, you first had to find it in either the back of the newspaper (if it was a mainstream issue) or large books put together by firms like Moody's and Value Line (if it was more thinly traded). Then you had to either send a request to the company for the annual report or go to the library hoping to find a copy of the report or a broader publication that included the company's financial statements. And third, with the industry so small, nascent and unpopular, the investment thought process wasn't something broadly developed or disseminated. The key analytical frameworks were not yet codified, and folks like Graham and Buffett had a huge edge simply because they knew how to process the data they found. In short, there were few people searching; the search process was quite difficult; and few people knew how to turn the data they did find into profitable investment conclusions. In this environment, bargains could literally be hiding in plain sight for anyone with the willingness to look and the capacity to analyze.

When Buffett was applying his cigar butt approach to running his early investment partnership – which racked up a tremendous record – he famously used to sit in his back room in Omaha, flipping through the thousands of pages of *Moody's Manual*, and he would buy shares in small companies that were trading at enormous discounts from liquidation value for the simple reason that no one else paid attention to them. In one case, that of National American Fire Insurance, Buffett was able to buy the stock at 1x earnings by driving around to farmers who had decades earlier been stuffed by promoters with stock they'd since forgotten about, and handing them cash on their front porch. Thus, the Grahamian value framework was created at a time when things could be stupidly cheap based on clearly observable facts, simply because the search process was very difficult and opaque.

As time went on, the diligent analyst's information advantage began to slowly dissipate, but it still existed for a good while. Prior to the broad adoption of the Internet and the explosion of the investment industry in the early years of this century, information and analytical methods were still hard to come by. One still had to mail away for annual reports as recently as the 1990s, and while more people may have known how to find pure balance sheet arbitrages like Graham practiced in the 1950s and '60s, seemingly basic analytical concepts like return on invested capital, competitive moats and the importance of free cash flow (rather than GAAP earnings) were not widely appreciated. And certainly, most people didn't understand the dynamics around what are called "special situations," which become available when complex corporate actions create investment opportunities by giving rise to significant mispricings. There was still the opportunity to find bargains in plain sight, albeit perhaps with an extra level of sophistication required.

Fast forward to today, and everything has changed. The investment industry is wildly competitive, with tens of thousands of funds managing trillions of dollars. Investment management is one of the most desirable careers, prompting complaints about "brain drain" as intellectual prodigies eschew careers as world-changing scientists or inventors in exchange for jobs on Wall Street. Warren Buffett has evolved from a man buying cheap stocks in his home office to an international celebrity, with 50,000 investors from around the world making the pilgrimage to Omaha each year for the Berkshire Hathaway annual meeting. Information is incredibly ubiquitous, with seemingly endless amounts of data – not to mention books, articles, blogs and podcasts about investment methodologies and specific stock research – available on your mobile phone in seconds. And, not only is information broadly available and easily accessed, but billions of dollars are spent annually on specialized data and computer systems designed to suss out and act on any discernable dislocation in the marketplace. All this is largely motivated by the fact that many of the greatest fortunes made in the last forty years belong to people in the investment profession. In contrast, when I entered the business in the late 1960s, few investors were "household names," investment industry incomes were in line with those in other professions, and only a handful of investors had a "carried interest" in their clients' profits.

In the past, bargains could be available for the picking, based on readily observable data and basic analysis. Today it seems foolish to think that such things could be found with any level of frequency. If something about a company can be easily read in an annual report, or readily discovered by a mathematically competent analyst or a computer, it stands to reason that, in most cases, this should already be appreciated by the marketplace and thus incorporated in the prices of the company's securities. That's the essence of the Efficient Market Hypothesis. Thus, in the world we live in today, investing on the basis of rote formulas and readily available fundamental, quantitative metrics should not be particularly profitable. (This is not necessarily true during market downturns and panics, when selling pressure can cause prices to decouple from fundamentals.) **It also stands to reason that in a time when readily discernable quantitative data is unlikely to produce high-profit opportunities:**

- **if something carries a low valuation, there's probably a good reason, and**
- **successful investing has to be more about superior judgments concerning (a) qualitative, non-computable factors and (b) how things are likely to unfold in the future.**

Not Your Grandfather's Market

Not only are the traditional staples of classic value investing (readily discernable quantitative measures of cheapness in the here-and-now) no longer likely to produce a sustainable edge on their own, but the world has gotten more complex, with many more dynamics that can drive a decoupling of near-term metrics from valuation, both to the positive and negative.

Back in the old days, Warren Buffett could find businesses that clearly were likely to remain dominant for long periods of time and perform relatively straightforward analysis to assess their valuation. For instance, he could look at something like the Washington Post, which essentially became the monopoly newspaper in a major city, and invest on the basis of reasonable, consistent assumptions regarding a few variables like circulation, subscription prices and ad rates. It was a foregone conclusion that the paper would remain dominant because of its strong moat, and thus that the past would look very much like the future. In contrast today:

- Because markets are global in nature, and the Internet and software have vastly increased their ultimate profit potential, technology firms or technologically aided businesses can grow to be much more valuable than we previously could have imagined.
- Innovation and technical adoption are happening at a much more rapid pace than ever before.
- It has never been easier to start a company, and there has never been more capital available to fund entrepreneurship.
- There have also never been as many highly capable people focused on starting and building companies.
- Since many of these companies are selling products primarily made with code, their costs and capital requirements are extremely low and their profitability – especially on incremental sales – is unusually high. Thus, the economics of winners have never been more attractive, with very high profit margins and minimal capital requirements.

- Because the friction and marginal cost of scaling over the Internet can be so low, businesses can grow much more rapidly than ever before.
- It has never been more acceptable for public companies to lose money in the pursuit of a large prize down the road. This in turn leads to obfuscation of the real potential economics of winners and makes differentiating between winners and losers difficult without great, insightful effort to peel back the onion.
- As developing and scaling new products is much easier in the digital world (often requiring little more than engineers and code), it's never been more possible for companies to develop completely new avenues of growth, further extending their runways (Amazon's AWS and Square's Cash App are two notable examples). This gives real value to intangibles such as exceptional management, engineering talent and strategic positioning with customers.
- The moats protecting today's winners have never been stronger, and as Brian Arthur pointed out in "Increasing Returns and the New World of Business," his amazing piece of almost 25 years ago, the winners often get stronger and more effective as they get bigger, rather than bloated and inefficient.
- Conversely, the onslaught of startups with readily available capital and minimal barriers to scaling means that the durability of legacy businesses has never been more vulnerable or uncertain.
- At the same time, however, it's important to recognize that the leading tech firms face threats from trustbusters who believe these companies have developed excessive market power.

To summarize, businesses are both more vulnerable and more dominant in today's world, with much greater opportunities for dramatic changes in fortune, both positive and negative. On the positive side, successful businesses have much more potential for long runways of high growth, superior economics, and significant durability, creating a huge pot of gold at the end of the rainbow and seemingly justifying valuations for the potentially deserving that are off-puttingly high by historical standards. On the negative side, it also creates immense temptation for investors to overvalue undeserving companies. And companies with here-and-now cash flows and seeming stability can see those evaporate as soon as a bunch of Stanford computer science students get funding and traction for their new idea.

When I consider this new world, I think fundamental investors need to be willing to thoroughly examine situations – including those with heavy dependency on intangible assets and growth into the distant future – with the goal of achieving real insight. However, this is, to an extent, antithetical to the value investor's mentality. Part of what makes up the value investor's mindset is insistence on observable value in the here-and-now and an aversion to things that seem ephemeral or uncertain. **Many of the great bonanzas for value investors have come in periods of panic following the bursting of bubbles, and this fact has probably led value investors to be very skeptical of market exuberance, especially when concerning companies whose assets are intangible.** Skepticism is important for any investor; it's always essential to challenge assumptions, avoid herd mentality and think independently. Skepticism keeps investors safe and helps them avoid things that are "too good to be true."

But I also think skepticism can lead to knee-jerk dismissiveness. While it's important not to lose your skepticism, it's also very important in this new world to be curious, look deeply into things and seek to truly understand them from the bottom up, rather than dismissing them out of hand. I worry that value investing can lead to the rote application of formulas and that, in times of great change, applying formulas that are based on past experience and models of the prior world can lead to massive error. John Templeton warned about the risk that's created when people say, "it's different this time," but he also allowed that 20 percent of the time they're right. Given the rising impact of technology in the 21st century, I'd bet that percentage is a lot higher today.

It's also worth noting with regard to truly dominant companies that are able to achieve rapid, durable and highly profitable growth that it is very, very hard to overprice them based on near-term multiples. The basic equations of finance were not built to handle high-double-digit growth as far as the eye can see, making the valuation of rapid growers a complicated matter. As John Malone famously said, if your long-term growth rate exceeds your cost of capital, your present value is infinite. **However, this is only true for truly special companies, which are few and far between and certainly not as ubiquitous as is generally implied by the market in times of ebullience.** It's important to note, that when markets are at extreme levels of optimism, as we saw in both the Nifty Fifty and Dot Com bubbles, (a) every company in the affected field is treated as a long-term winner, (b) if bought in times of significant optimism and extreme valuations for growth, the stocks of even the greatest companies are likely to produce outcomes that are mediocre at best, and (c) in the crashes that follow most bubbles, enormous interim markdowns can befall good companies as well as bad, requiring sharp analysis to differentiate between them, and high conviction and an iron stomach to hold on.

I want to make very clear that I do not intend this to imply an opinion about growth stocks' valuations today. I've heard a variety of views, and while I have my own, I don't want to make it the subject of this memo. In the spirit of seeking to understand this new world, market commentators (including me) would be well served to understand the fundamentals underpinning the small number of companies that currently drive a huge percentage of the market, instead of basing top-down conclusions on purely historical valuation comparisons. And it seems imprudent to opine on the level of the overall market without being fully informed regarding the tech companies that now account for so much of equity indices like the S&P 500. As Andrew repeatedly reminds me, it's hard to make a convincing case that today's market is too high if you can't explain why its tech leaders are overvalued.

But by far the most important intention of this memo is to explore the mindset that I think will prove most successful for value investors over the coming decades, regardless of what the market does in the years just ahead. It's important to note that (a) the potential range of outcomes for many of today's companies is very wide and (b) there are considerations with enormous implications for the ultimate value of many companies that do not show up in readily available quantitative metrics. They include superior technology, competitive advantage, latent earning power, the value of human capital as opposed to capital equipment, and the potential option value of future growth opportunities. In other words, determining the appropriateness of the market price of companies today requires deep micro-understanding, and that makes it virtually impossible to opine on the valuation of a rapidly growing company from 30,000 feet or by applying traditional value parameters to superficial projections. **Some of today's lofty valuations are probably more than justified by future prospects, while others are laughable – just as certain companies that carry low valuations can be facing imminent demise, while others are just momentarily impaired.** The key, as always, is to understand how today's market price relates to the company's broadly defined intrinsic value, including its prospects.

<u>The Heart of the Problem</u>

Consider two companies. Company A is a respected long-term competitor selling a widely consumed, fairly prosaic product. It has built a decades-long record that shows modest but steady sales growth and healthy profit margins. It manufactures its product using heavy machinery located on its own premises. Its stock sells at a modest multiple of earnings per share.

Company B, on the other hand, was formed a few years ago with the goal of disrupting a legacy industry. It has a brief but impressive record of sales growth, albeit at modest absolute dollar levels and with limited profitability. It plans to accelerate its sales growth and build market share over the next several years, overtake its more traditional prey, and then expand its profit margins by tapering spending on R&D and customer acquisition, raising prices, and scaling into its largely fixed cost structure. Its products are constantly evolving and innovating, and they emerge not from factories, but rather the minds of engineers doing coding. It has no current earnings, but because of its potential, sells at a lofty multiple of sales.

Value investors are likely to consider it easy to predict and value Company A, with its time-tested product, stable revenues, well-established profit margins and valuable production facilities. The process requires only a few simple assumptions: that something that has been successful will remain so; that next year's sales will be equal to this year sales plus some modest growth; and that the profit margin will remain where it has been for years. **It seems intuitively obvious that chugging along as in the past is more predictable and reliable than rapid and durable growth, and thus that industrial stalwarts are more capable than innovators of being valued with precision.**

Company B, on the other hand, is at an early stage in its development, its profit margins are far from maximized, and its greatest assets go home every night rather than residing on the balance sheet. Valuing it requires guesses about the ultimate success of its products; its ability to come up with new ones; the response from competitors and the targeted industry; its growth runway; and the extent to which it will be able to increase profitability once doing so becomes its focus. Company B seems more conceptual in nature and more dependent on developments in the distant future that are subject to significant uncertainty, so valuing it might have to be done on the basis of broad ranges for future sales and profitability rather than reliable point estimates. Assessing its value also requires conversance with a technologically complex field. For all these reasons, value investors are likely to consider Company B hard to value, "speculative" and thus not investable under the canon.

Certainly, the range of potential outcomes – both good and bad – appears greater with respect to Company B than Company A, and thus Company B seems less predictable. But Company A's track record may suggest stability that could ultimately prove fleeting. And even if one can't exactly predict the future of Company B, British philosopher and logician Carveth Read reminds us that we'd rather be vaguely right than exactly wrong. The ability to formulate precise forecasts does not necessarily make something a better or even a safer investment.

- **First, the apparent ease of predicting traditional Company A's future can be quite deceptive** – for example, considerable uncertainty can exist regarding its risk of being disrupted by technology or seeing its products innovated out of existence. On the other hand, while Company B is more nascent, its products' strength and traction in the marketplace may make success highly likely.
- **Second, as noted earlier, if conclusions regarding Company A's potential can easily be reached by a finance student with a laptop, how valuable can such conclusions be?** Shouldn't a deep understanding of a company's qualitative dynamics and future potential be a greater source of advantage in making correct forecasts than data which is readily available to all?

Value investing is thought of as trying to put a precise value on the low-priced securities of possibly mundane companies and buying if their price is lower. And growth investing is thought of as buying on the basis of blue-sky estimates regarding the potential of highly promising companies and paying high valuations as the price of their potential. **Rather than being defined as one side of this artificial**

dichotomy, value investing should instead consist of buying whatever represents a better value proposition, taking all factors into account.

Dealing with Winners

A couple of times this past year, I've committed the sin of asking Andrew how he felt about selling part of some highly appreciated holdings and "taking some money off the table." The results haven't been pretty; he has made plain my error, as described below.

Much of value investing is based on the assumption of "reversion to the mean." In other words, "what goes up must come down" (and what comes down must go up). Value investors often look for bargains among the things that have come down. Their goal, of course, is to buy underpriced assets and capture the discounts. But then, by definition, their potential gain is largely limited to the amount of the discount. Once they've benefitted from the closing of the valuation gap, "the juice is out of the orange," so they should sell and move on to the next situation.

In Graham's day, cigar butts could be found in good supply, valued precisely, bought very cheaply with confidence, and then sold once the price had risen to converge with the value. But Andrew argues that this isn't the right way to think about today's truly world-class companies, with their vast but unquantifiable long-term potential. Rather, if an investor has studied a company, reached a deep understanding of it and concluded that it possesses great potential for growth and profitability, he'll probably recognize that it's impossible to accurately quantify that potential and know when it has been realized. He also may realize that ultimate potential is a moving target, as the company's strengths may allow it to develop additional avenues of growth. **Thus he might have to accept that the correct approach is to (a) hope he has the direction and quantum approximately right, (b) buy and (c) hold on as long as the evidence suggests the thesis is right and the trend is upward – in other words, as long as there's still juice in the orange.**

My 2015 memo *Liquidity* included some observations from Andrew regarding point "c":

> When you find an investment with the potential to compound over a long period of time, one of the hardest things is to be patient and maintain your position as long as doing so is warranted on the basis of the prospective return and risk. Investors can easily be moved to sell by news, emotion, the fact that they've made a lot of money to date, or the excitement of a new, seemingly more promising idea. **When you look at the chart for something that's gone up and to the right for 20 years, think about all the times a holder would have had to convince himself not to sell.**

He hasn't changed his tune one bit over the last five years. **Andrew insists that when you're talking about today's great growth companies, the approach of "buy in cheap, set a target price, sell as it rises, and exit fully when it reaches the target" is dead wrong.** A dispassionate look at history makes clear that taking profits in a rapidly growing company with durable competitive advantages has often been a mistake. Given the properties of today's leading companies, it can be even more wrong now. **Instead, as he says, you have to talk yourself out of selling.**

I think winners are sold for four primary reasons: (a) the investor concludes that the investment has accomplished everything it's capable of, (b) she thinks it has appreciated to the point that its prospective return is only modestly attractive, (c) she realizes something in her investment thesis was incorrect or has changed for the worse or (d) she fears that the gains to date might be proved unwarranted and thus evaporate; in particular, she's afraid she'll end up kicking herself for not having taken profits while they were there. But fear of making a mistake is a terrible reason to sell something of value.

Here's how Andrew puts it today:

> It's important to understand the paramount importance of compounding, and how rare and special long-term compounders are. This is antithetical to the "it's up, so sell" mentality but, in my opinion, critical to long-term investment success. As Charlie Munger says, "the first rule of compounding is to never interrupt it unnecessarily."
>
> In other words, if you have a compounding machine with the potential to do so for decades, you basically shouldn't think about selling it (unless, of course, your thesis becomes less probable). Compounding at high rates over an investment career is very hard, but doing it by finding something that doubles, then moving on to another thing that doubles, and so on and so on is, in my opinion, nearly impossible. It requires that you develop correct insights about a large number of investment situations over a long period of time. It also requires that you execute well on both the buy and the sell each time. When you multiply together the probabilities of succeeding at a large number of challenging tasks, the probability of doing them all correctly becomes very low. It's much more feasible to have great insights about a small number of potentially huge winners, recognize how truly rare such insights and winners are, and not counteract them up by selling prematurely.

As I was working on this memo, I came across a very helpful article from the Santa Fe Institute:

> When it comes to investing and businesses, the mental models in our head help us answer the question, '*what does the future hold?*'. . . [But] applying the mental model of '*mean reversion*' for a '*fade-defying*' business model will lead to an erroneous conclusion. (*Investment Master Class*, December 21, 2020)

The last sentence struck a very responsive chord in me. **It suggested to me that my background had biased me toward assuming "mean reversion" and thus sometimes caused me not to fully grasp the potential of "fade-defying business models."** This bias caused me to conclude that one should "scale out" of things as they rose and "take some money off the table." I even formulated a saying on the subject: "If you sell half, you can't be all wrong." But I now see that this high-sounding verbiage can lead to premature selling, and that cutting back a holding with great potential can be a life-altering mistake. Note that, according to Charlie Munger, he's made almost all his money from three or four big winners. What if he had scaled out early?

Fortunately, (a) Oaktree's business consists mostly of garnering valuation discrepancies; (b) because of their nature, our asset classes offer up relatively few opportunities to err by prematurely selling off potential mega-multiple winners; (c) Oaktree's decentralized structure insulates our portfolio managers from the extremes of my caution; and (d) my colleagues do a better job of letting their winners run than I might have. We might have done more if I didn't have my limitations. Maybe I could have remained in equities, or even become a venture capitalist and seeded Amazon. But I can't complain – things couldn't have turned out better.

The Value Mentality in Action

Back in 2017, my memo *There They Go Again . . . Again* included a section on cryptocurrencies in which I expressed a high level of skepticism. This view has been a source of much discussion for me and Andrew, who is quite positive on Bitcoin and several others and thankfully owns a meaningful amount for our family. While the story is far from fully written, the least I can say is that my skeptical view has not borne out to date. This brings up what Andrew considers a very important point about the value investor's mentality and what is required for success as an investor in today's world.

As I said before, the natural state for the value investor is one of skepticism. Our default reaction is to be deeply dubious when we hear "this time it's different," and we point to a history of speculative manias and financial innovations that left behind significant carnage. It's this skepticism that reduces the value investor's probability of losing money.

However, in a world where so much innovation is happening at such a rapid pace, this mindset should be paired with a deep curiosity, openness to new ideas, and willingness to learn before forming a view. The nature of innovation generally is such that, in the beginning, only a few believe in something that seems absurd when compared to the deeply entrenched status quo. When innovations work, it's only later that what first seemed crazy becomes consensus. **Without attaining real knowledge of what's going on and attempting to fully understand the positive case, it's impossible to have a sufficiently informed view to warrant the dismissiveness that many of us exhibit in the face of innovation.**

In the case of cryptocurrencies, I probably allowed my pattern recognition around financial innovation and speculative market behavior – along with my natural conservatism – to produce my skeptical position. These things have kept Oaktree and me out of trouble many times, but they probably don't help me think through innovation. Thus, I've concluded (with Andrew's help) that I'm not yet informed enough to form a firm view on cryptocurrencies. In the spirit of open-mindedness, I'm striving to learn. Until I do, I'll be referring all requests for comments on the subject to Andrew (although I'm sure he'll decline).

Back to the Original Question

I'll move toward ending this memo by turning to the question I mentioned at the outset: Is the recent underperformance of value investing a temporary phenomenon? Will value stocks ever again have their day in the sun?

First, I think the stocks of the tech leaders are clearly being aided by a virtuous circle created by the combination of their preeminence as companies, their recent eye-popping performance, their huge market capitalizations, and the strategic considerations of the fund business. The companies' preeminence and price momentum make them essential cornerstone holdings in many ETFs, and their enormous scale places them among the largest holdings. They also dominate equity indices such as the S&P 500. Those two things mean that as long as money flows disproportionately into ETFs and index funds and the four factors enumerated above don't change, the leading tech stocks will continue to attract more than their fair share of capital and perform better than stocks not as well represented in the indices and ETFs.

However, this is one of those trends that will continue until it stops. To the extent investors' expectations for these companies' rapid growth are realized, they can continue to be great performers. But at some point, if they keep appreciating faster than the rest of the stock market, there should come a time when even their superior growth rates are fully reflected in their stock prices and their performance should subside: their stock prices may grow "only" in line with their earnings or even slower. And other stocks may come into favor and perhaps outperform. But importantly, there's no reason why this has to happen anytime soon.

There are many similarities between today and past periods of optimism. There's immense excitement about investing in high-growth stocks, fueling continued rapid appreciation. There's very easy monetary policy, which adds fuel to the fire in any bull market. There are pockets of extreme behavior, with 30-40x sales multiples not uncommon for software businesses, and with high-priced IPOs doubling on their first trading day. But there are real differences as well. We've rarely had businesses as dominant as the tech leaders, with the growth runways they have and the profit margins and capital efficiency they enjoy making them more dominant with each passing day. We've never seen businesses with the ability to scale as rapidly and frictionlessly. We've never had such a catalyst for technology adoption as we've had in the coronavirus pandemic. We've had a boom of new public companies coming to market, both through IPOs and SPACs, reversing the long trend of a shrinkage in the number of public companies. We've never had interest rates as low as they are and as likely to stay low for as long as has been telegraphed. The Internet has permeated the world and changed it, and business models have evolved in a way that makes today's situation incomparable to the Nifty Fifty or the Dot Com Bubble of the late '90s (for example, in 1998 there were 150 million Internet users globally; today there are more than that in Indonesia alone).

I believe most types of investment are likely to go through periods of both outperformance and underperformance. There are reasons to believe (with ample counterarguments) that as the tide turns on monetary policy (if it ever does), rising interest rates will disproportionately hurt growth stocks, just as they've been disproportionately helped during this period of easy money. More importantly, it has long been true that when something works, people follow the herd, chase the gains, and bid it up to the point where prospective returns are paltry, thus positioning investments that have been out of favor to become the new outperformers. **But, as I said earlier, broad observations about historic valuations are not a sufficient foundation for market opinions today.** I also believe, as outlined earlier, that certain types of value opportunities have largely evaporated and, save for times of market panic when things become dislocated, are unlikely to deliver the returns they did in the past.

In short, there are arguments for a resurgence in value investing and arguments for its permanent impairment. But, I think this debate gives rise to a false and unhelpful narrative. The value investor of today should dig in with an open mind and a desire to deeply understand things, knowing that in the world we live in, there's likely more to the story than what appears on the Bloomberg screen. **The search for value in low-priced securities that are worth much more should be just one of many important tools in a toolbox, not a hammer constantly in search of a nail. It doesn't make sense for value investors to bar investments simply because (a) they involve high-tech companies that are widely considered to have unusually bright futures, (b) their futures are distant and hard to quantify, and (c) their potential causes their securities to be assigned valuations that are high relative to the historic averages. The goal at the end of the day should be to figure out what all kinds of things are worth and buy them when they're available for a lot less.**

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To end, I'll pull together what I consider the key conclusions:

- Value investing doesn't have to be about low valuation metrics. Value can be found in many forms. The fact that a company grows rapidly, relies on intangibles such as technology for its success and/or has a high p/e ratio shouldn't mean it can't be invested in on the basis of intrinsic value.
- Many sources of potential value can't be reduced to a number. As Albert Einstein purportedly said, "Not everything that counts can be counted, and not everything that can be counted counts." The fact that something can't be predicted with precision doesn't mean it isn't real.
- Since quantitative information regarding the present is so readily available, success in the highly competitive field of investing is more likely to be the result of superior judgments about qualitative factors and future events.
- The fact that a company is expected to grow rapidly doesn't mean it's unpredictable, and the fact that another has a history of steady growth doesn't mean it can't run into trouble.
- The fact that a security carries high valuation metrics doesn't mean it's overpriced, and the fact that another has low valuation metrics doesn't mean it's a bargain.
- Not all companies that are expected to grow rapidly will do so. But it's very hard to fully appreciate and fully value the ones that will.
- If you find a company with the proverbial license to print money, don't start selling its shares simply because they've shown some appreciation. You won't find many such winners in your lifetime, and you should get the most out of those you do find.

I once asked a well-known value investor how he could hold the stocks of fast-growing companies like Amazon – not today, when they're acknowledged winners, but rather two decades ago. His answer was simple: "They looked like value to me." **I guess the answer is "value is where you find it."**

My conversations with Andrew over the ten months of the pandemic have represented a "voyage of discovery" and culminated in this memo. I think we came to some important realizations regarding the question of value versus growth investing, and in the process, I learned a lot about myself.

I don't mean to suggest that anything I've written here pertains to all value or all growth investors. There's a lot of generalizing, and we know how imperfect generalizations can be. I also don't insist that it's correct. It's just the current state of my thinking. Not only do I not insist that my version is the only one possible, but I expect it to evolve further as the world changes and I continue to learn. I hope you'll find this memo interesting and helpful, and I wish you all the best in 2021.

January 11, 2021

Appendix: Dealing with Winners in Practice

The conclusions described above regarding how to deal with winners shouldn't be taken to mean it was easy for Andrew and me to reach agreement on this subject. The discussion here was our most spirited, and we returned to it many times. Our talks usually went something like this:

Howard: Hey, I see XYZ is up xx% this year and selling at a p/e ratio of xx. Are you tempted to take some profits?

Andrew: Dad, I've told you I'm not a seller. Why would I sell?

H: Well, you might sell some here because (a) you're up so much, (b) you want to put some of the gain "in the books" to make sure you don't give it all back and (c) at that valuation, it might be overvalued and precarious. And, of course, (d) no one ever went broke taking a profit.

A: Yeah, but on the other hand, (a) I'm a long-term investor, and I don't think of shares as pieces of paper to trade, but as part ownership in a business, (b) the company still has enormous potential, and (c) I can live with a short-term downward fluctuation, the threat of which is part of what creates opportunities in stocks to begin with. Ultimately, it's only the long term that matters. (There's a lot of a-b-c in our house. I wonder where Andrew got that.)

H: But if it's potentially overvalued in the short term, shouldn't you trim your holding and pocket some of the gain? Then if it goes down, (a) you've limited your regret and (b) you can buy in lower.

A: If I owned a stake in a private company with enormous potential, strong momentum and great management, I would never sell part of it just because someone offered me a full price. Great compounders are extremely hard to find, so it's usually a mistake to let them go. Also, I think it's much more straightforward to predict the long-term outcome for a company than short-term price movements, and it doesn't make sense to trade off a decision in an area of high conviction for one about which you're limited to low conviction.

H: Well for one thing, the p/e ratio is awfully high.

A: The p/e ratio is just a very quick heuristic that doesn't necessarily tell you much about the company. You can't say a stock is overvalued just because its p/e ratio is high relative to historic average p/e's for the market. All that matters is thinking about how much cash flow the company can produce over a long period of time, discounting that at a reasonable discount rate, and comparing the resultant present value against the current price. There are lots of things – about both the company's present condition and its future potential – that don't get picked up in a p/e ratio, so a high multiple alone shouldn't scare you off.

H: Aha! That's just what they said during the Nifty Fifty bubble around the time I started working. "No price too high," was a widespread mantra. Coca-Cola reached 46x earnings at the height of the bubble in mid-1972 – 2.4x the p/e on the S&P 500. From there it fell 65% over the next year and a half.

A: First, saying a high p/e alone shouldn't stop you from owning something doesn't mean there's no price too high. It simply means that no single metric can hold the key to investment decisions, and the price of something should be weighed against its fundamental potential. Coke may have been overvalued in 1972 at its p/e of 46. In particular, since it dealt in a physical product and required incremental capital to grow, it didn't have potential for exponential growth. But note that Coke holders did earn a compound return of 16% percent a year for 26 years even if they bought at the 1972 pre-crash high. So, even without the growth prospects of today's best businesses, companies that can compound earnings at high rates can merit very high p/e ratios.

H: Aren't you concerned that if the leading stocks of today go out of style, you could see XYZ down a third or more?

A: Stocks can go in and out of style, causing their prices to fluctuate wildly. And when a group is in vogue, it may be more likely to experience a reversal. But, at the end of the day, all I care about is this specific company and its long-term potential which, even when using conservative assumptions, I find to be immense relative to its current price. Seeing it fall wouldn't be fun, but I think selling here and missing out on part of that future would be far worse. Some years XYZ may do well, and some years it may do poorly (even perhaps very poorly). But if I'm right, I think it has a great long-term future ahead of it. The only way to be sure we participate in that future is to hold on throughout. And, by the way, if you don't sell, you get to compound without paying capital gains taxes until the end.

H: You run a concentrated portfolio. XYZ was a big position when you invested, and it's even bigger today, given the appreciation. Intelligent investors concentrate portfolios and hold on to take advantage of what they know, but they diversify holdings and sell as things rise to limit the potential damage from what they don't know. Hasn't the growth in this position put our portfolio out of whack in that regard?

A: Perhaps that's true, depending on your goals. But trimming would mean selling something I feel immense comfort with based on my bottoms-up assessment and moving into something I feel less good about or know less well (or cash). To me, it's far better to own a small number of things about which I feel strongly. I'll only have a few good insights over my lifetime, so I have to maximize the few I have.

H: Isn't there any point where you'd begin to sell?

A: In theory there is, but it largely depends on (a) whether the fundamentals are playing out as I hope and (b) how this opportunity compares to the others that are available, taking into account my high level of comfort with this one.

H: If there's a point at which you'd start to sell, what it is? Isn't setting a target price based on intrinsic value an important part of value investing?

A: This company can't be valued with a single number – and it's not a mature company with a fixed value I'm trying to capture – so I can't tell you where I'd start to sell. There are a lot of moving parts; most importantly, it has very strong management that I believe will continue to leverage the company's strong position in the marketplace to develop new avenues of growth. I can't say what those will be, or how they'll be valued, but I'm confident the team will continue to add value. Amazon is the classic example; it created a completely new business out of nothing, AWS, that today accounts for a large percentage of the company's total market value. Selling should be a function of watching how the future develops relative to your expectations and weighing the opportunity as it stands at any point in time against whatever else is out there.

H: Okay. I'm convinced. I hope you hold on!

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Memo to: Oaktree Clients Only

From: Howard Marks

Re: 2020 in Review

The opening lines of Charles Dickens's *A Tale of Two Cities* offer a fitting coda to 2020:

> It was the best of times, it was the worst of times . . . it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair.

We're left to contemplate the jaw-dropping list of extremes compiled during this turbulent year:

- The coronavirus brought on the worst global pandemic in over a century.
- In the U.S., more than 340,000 people died from Covid-19 – 85% of the number who died in battle in the four years of World War II.
- In the second quarter, the U.S. experienced the worst quarterly drop in real GDP in 74 years of recorded quarterly history, an annualized decline of 32.9%.
- But in the third quarter, it saw the biggest annualized gain in history: 33.4%.
- Initial unemployment claims jumped from 251,000 to almost 3 million in a single week in March, crested at 6.2 million two weeks later, and remained above the pre-pandemic record of 695,000 every week for the remainder of the year.
- Through bond buying, the Federal Reserve grew its portfolio by $2.7 trillion, or roughly 55%, and the U.S. Treasury funded roughly $4 trillion in grants and loans.
- After the S&P 500 Index reached an all-time high of 3,386 on February 19, it fell 33.9% in just 32 days to 2,237 on March 23.
- But from that low, the index regained the previous high in less than five months on August 18 (an increase of 51.5%). It ended 2020 up 67.9% from the low and up 18.4% overall for the year.
- Unlike the credit crunches that accompanied many past crises, capital flowed like water. High yield bond issuance for the year was $450 billion, up 57% from 2019 and well above the prior record set in 2013. Investment grade debt issuance totaled $1.9 trillion, up a similar 58% from 2019 and also ahead of the previous record, set in 2017.
- After the Fed cut its federal funds rate target to between zero and 0.25%, bond prices rose as bond yields fell in parallel. At year-end, the average A-rated bond yielded just 1.52%, and the average yield on high yield bonds (ex. energy) was just below 4%.

So we had a health emergency, an ailing economy, the most generous capital market of all time, and strong stock and bond markets. The seemingly anomalous relationship between the pandemic and recession on one hand and the strong capital and stock markets on the other can be explained by the Fed's and the U.S. Treasury's aggressive actions.

As suggested by the above catalog of events, the buying opportunity in 2020 turned out to be very brief, especially with regard to public securities and companies with the ability to access the capital markets. Defaults affected a large dollar amount of high yield debt securities, but default rates came nowhere near the highs that had been predicted and soon began to recede. Highly motivated selling was short-lived – essentially limited to the month of March – and we never saw the full-throated panic (accompanied by margin calls, meltdowns and forced selling) witnessed in prior crises. In just a few months:

- investors grew confident about the inevitability of an economic recovery;
- optimism developed regarding the outlook for a Covid-19 vaccine;
- the near-zero fed funds rate brought down prospective returns all along the capital market line;
- risk tolerance returned, and fear of missing out took over from fear of losing money;
- asset prices rose, and the markets bounced back; and
- the exceptional buying opportunity came to what for our purposes was a premature end.

Oaktree Performance

Last year's extreme, rapid-fire developments – and especially their origin in an exogenous and unforeseeable event, the virus outbreak – created great challenges for investors. To have taken maximum advantage, one would have had to have gone into late February prepared for a significant shock and then turned bullish a month later. Obviously, few investors did both.

While we never radically shift our portfolios, I think Oaktree did a very good job under these circumstances. For years we had been leery of the markets, because of our view that they were characterized by a great deal of uncertainty, full-to-high asset prices, the lowest prospective returns in history, and pro-risk behavior on the part of investors trying for high returns in a low-return world. With our mantra in that period of "move forward, but with caution," our portfolios were as fully invested as we could make them while maintaining the highest possible standards within the context of the market realities.

When the markets fell sharply in March, our prior caution allowed 10 of our 14 open-end strategies to avoid part of their benchmarks' declines (before fees). This enabled us to remain calm under fire, hold onto positions that warranted doing so, and increase aggressiveness at the margin where appropriate. Of course, these were the right things to do.

A year ago, in my 2019 review, I included a table showing how little of our closed-end funds' capital we had invested, taking pride in our portfolio managers' discipline, and writing:

> Investors' aggressive pursuit of return – and the strong resulting cash flows into alternative and private investments – has made it challenging to put money to work in these fields. . . . In each case, our insistence on good value and controlled risk resulted in a moderate pace of investment that was somewhat below our historic norms.

In 2020, in contrast, many of our closed-end strategies turned highly aggressive, starting in the worst of the March declines. This allowed them to make great progress. For example:

- Our Opportunities group bought public debt and negotiated private rescues in quantities sufficient to complete the deployment of Opportunities Fund Xb by investing over $7 billion and then put over $4 billion to work for its successor, Opps XI.
- The same was true of our Real Estate group, which finished investing Real Estate Opportunities Fund VII and moved on to ROF VIII.
- The investments made by our Special Situations group took the invested or committed percentage of its Special Situations Fund II from 19% to 82%.
- Overall, Oaktree's closed-end funds deployed nearly $17 billion, making 2020 our best year ever in that regard.

Given our insistence on risk control, Oaktree's open-end strategies don't always keep up with their benchmarks in highly bullish times. The fourth quarter of 2020 presented a potential challenge in that regard, as the market rally (and the low interest rates) encouraged risk-taking and caused the riskiest assets to soar. Thus, we're happy to report that 10 of the 14 strategies exceeded their benchmarks in the fourth quarter, allowing 9 of them to do so for the full year (all references to returns are before fees). Further, the ups and downs of our quarterly returns suggest we earned our returns with less volatility than the benchmarks. Overall, we're quite pleased with Oaktree's investment performance for the year.

To reiterate what you already know, none of this was predicated on forecasts. We never tried to predict when the markets would begin to recover from their Covid-19-induced declines. We didn't know better than anyone else that the new signs of life in the markets in late March were the beginnings of a rally that would take them to all-time highs. We simply favored defensiveness when we considered the markets vulnerable and then turned aggressive when price declines rendered defensiveness no longer appropriate.

A Look at the Long Run

At the end of the most turbulent year in my five-plus decades of experience, I'm going to devote my usual section on the long run to an Oaktree strategy that really would make you think 2020 was the best of times: our Power Opportunities funds. I'll start with the interesting history of these funds.

Just a year after Oaktree's founding, a friend brought us an unusual opportunity. Three long-term corporate-employees-turned-energy-consultants had left Arthur Andersen in 1995 to form an investment boutique, GFI Energy Ventures (with "GFI" standing for "Go For It"). Larry Gilson, Richard Landers and Ian Schapiro had developed an investment thesis based on their knowledge advantage regarding the deficiencies of the U.S. power infrastructure, the need for remediation and expansion, and what the incumbents would spend money on in the process. They were a sponsor without a fund, passing the hat among a small circle of investors whenever they found an attractive investment candidate. But, in 1996, they found an opportunity too large to finance using that approach, and they were referred to us.

We were very interested in that first investment, as well as the general thesis and its application, and we entered into a deal with GFI under which we would pay their overhead, get a right of first refusal on their deal flow, and jointly manage the investments made. And, if we continued to like what we saw, in three years we would organize a fund dedicated exclusively to their power infrastructure investments, which would also be run jointly. All went well during the period in question, and so the first Oaktree/GFI Power Opportunities Fund was formed in 1999.

While we tried to get the people of GFI to join Oaktree, Larry and Richard resisted our entreaties. But when they retired in 2009, Ian and his team jumped aboard, and we've had a great ride ever since. We're now in the process of investing Oaktree Power Opportunities Fund V.

A few specific things stand out to me about the last 25 years:

- When Bruce and I first met Larry, Richard and Ian, we were immediately struck by the strength of their thesis. Everyone knew the U.S. power grid was old and hadn't kept up with the country's progress. The frequent blackouts, among other things, told us it needed extensive (and expensive) remediation and investment.
- Interestingly, GFI didn't invest in power generation or transmission infrastructure, but rather in successful companies that sold products, services and software to firms involved "downstream" in the distribution, monitoring and consumption of power. In the words we used at the time,

"they won't try to predict which miners will find gold; they'll sell picks and shovels to all of them."

- When GFI gave us their drafts of the marketing materials for that first 1999 fund, there was extensive discussion, in a very Oaktree-like fashion, of the many types of risk they wouldn't take, such as technological risk and commodity risk. And they've stuck with that discipline.
- Larry, Richard and Ian also laid out the specific strategies that they would pursue based on the expected industry trends and company behavior. Those strategies are still guiding the Power funds to great success a quarter-century later. The GFI founders were remarkably prescient.
- Finally, it's worth observing that the Power Opportunities group has increased its capital under management only gradually. There can be little doubt that discipline in fundraising has had a favorable impact on investment results. It's simply an oxymoron to say, "I've found an incredible niche where great returns can be earned consistently and with little risk, and it's infinitely scalable." That just doesn't make sense. So, when the $1 billion Power Fund II compiled its net IRR of 59% – without its portfolio companies employing high leverage – I asked the group leaders how much capital they wanted for their next fund. The answer was simple: $1 billion. Certainly, the typical GP would have used the success of Fund II to raise far more for subsequent funds, perhaps bringing their record of exceptional performance to an end.

Lastly, I'm proud to report that the aggregate 2020 return of the Power Opportunities Funds was 131.1% net of fees, incentive allocation and expenses, and to present the lifetime performance of the constituent funds through December 31, 2020:

Power Opps Fund	Year Formed	Committed Capital	Net IRR	Multiple of Cost
I	2000	$ 453.8	13.1%	1.5x
II	2004	1,020.6	58.9	3.1
III	2010	1,062.1	13.4	1.6
IV	2016	1,105.7	29.9	2.5
V	2018	1,400.0	4.4	1.0
Total			26.5%	2.0x

It's easy to see why we're so proud of the Power Opportunities group. Not only is the average IRR for these funds very high, but individually they've always been good, sometimes astronomical, but never poor (in fact, never a mature fund with a net IRR below the low teens). Every Power fund has had a very high batting average and a very low incidence of loss. Power Fund IV's gross return of 200% in 2020 is the best we've ever had, and we believe it will turn out to be the highest returning fund of its size in U.S. private equity history in terms of MOIC, without highly leveraging its holdings. Until now, Power Fund II has held the #2 spot; it'll be bumped down to #3. **You can see why we feel the group's track record, with the surprises clearly on the upside, represents the Oaktree ideal to the fullest**.

The leadership of the Power Opportunities group has evolved and transitioned over these 25 years, but the talent keeps being regenerated and the returns roll on. Larry and Richard retired in 2009, as I said, and Ian took over. In 2016, Ian promoted Michael Cardito and Jason Lee to be his co-portfolio managers. Jason will be leaving us in the next few months to devote his energies to activities such as teaching, and while we're sorry to see him go, we're delighted to know he'll remain an informal advisor. At the same time, Ian is stepping back from managerial responsibilities and has passed the day-to-day reins to Michael. Since Michael has been responsible for much of the success of our most recent Power funds and

Ian will be fully involved in the investment process, we know the strategy continues to be in excellent hands. We thank the members of the Power Opportunities group for their long-term achievement. We're confident they'll continue to adhere to the Oaktree ideals of risk control and consistency, hopefully with further great success.

Oaktree Developments

Assets Under Management – Oaktree's assets under management changed little in the years leading up to 2020, only rising from $91 billion at year-end 2014 to $95 billion at year-end 2019 (in both cases excluding our share of DoubleLine's AUM). Given the market conditions, we opted to limit asset accumulation in order to maximize our ability to be selective. Further, Oaktree's overall ability to increase AUM largely depends on the state of the market for distressed debt, the focus of our largest funds, and supply there was very modest in those years. Consequently, our fundraising for that area – and thus for Oaktree overall – was quite restrained.

In contrast, 2020, with its many difficulties (including weak markets), seemed the perfect time to raise capital for our distressed debt strategy, and we brought forward the formation of Opportunities Fund XI from its planned date in 2021. In anticipation of a pronounced increase in the supply of candidates for investment, Opps XI became, we believe, the largest distressed debt fund ever formed, with capital commitments of $14.5 billion thus far.

In addition to Opps XI, in 2020, we went out for incremental capital for several of our strategies, including ongoing open-end and evergreen efforts and closed-end funds already in the market. The response was very favorable, permitting us to raise a total of $29.4 billion in 2020, the best year for total fundraising in Oaktree's history, as well as the best for strategies other than Opps. That lifted Oaktree's year-end AUM to $121 billion ex. DoubleLine ($148 billion overall). Importantly, we're confident this total – spread over more than two dozen strategies – allows us to remain selective and flexible.

Operations During the Pandemic – My first indication of the severity of the coronavirus came on February 26, when I was at the airport waiting to fly to see a state pension fund client. I received a call telling me that the client had to cancel my appointment, as they had established a no-visitors policy (along with a no-travel policy for their staff). That decision – which soon became so common – seemed jarringly serious at the time. (However, it permitted me to curtail my trip and attend Grandparents Day at Rosie's school – a real silver lining.)

On March 5, we made the decision to cancel the in-person version of Oaktree's biennial LP conference, scheduled for the 11th, and to livestream it instead. Nancy and I flew from New York to Los Angeles for the session, little knowing that we would be there for several months. I left the Beverly Hilton after the livestreaming sessions and, like many of you, haven't been back to the office since. As those who've read my memo *Something of Value* know, my son Andrew and his family moved in with us on March 13 for a period of months, and investment discussions with him added greatly to my productivity in 2020.

Oaktree employees soon reported our first two cases of Covid-19, and to date we've had 40+ cases among our roughly 1,000 staff members around the world. Fortunately, everyone recovered nicely. We closed all of our offices in early March, and the attendance picture since then has varied from office to office. We thank both those who've been coming in and those who've worked from home.

Oaktree's people made great efforts in 2020 and were extremely effective. And clearly, we're pleased with the results. Our systems operated without a hitch, and our people worked under difficult circumstances to help us seamlessly acquit our responsibility to our clients. I don't think we skipped a beat. And we all mastered the phrase that best symbolizes 2020: "you're on mute."

Ensuring Opportunity – One of the signal events of 2020 was the death of George Floyd at the hands of a Minneapolis policeman, a tipping point that ignited protests across the country. **Many American individuals and corporations were moved to recognize the racial inequalities and injustices that exist and to do something about them. We at Oaktree are very much part of that group.**

Since 2016, Oaktree has had a highly organized effort to improve the diversity and inclusiveness of our organization, led by separate leadership councils for women, people of color (Black, Hispanic/Latino and multi-racial) and LGBTQ employees. The councils have significant responsibility and influence with regard to recruiting, training, mentoring and retention, and they are charged with making sure these key functions are carried out well and bias is avoided. They serve as key advisers to Oaktree's senior management on these subjects. The councils are also mentoring college students from communities that have traditionally had limited access to opportunities in investment management and making great efforts to hire from those communities. We look forward to reporting on progress as it occurs.

As part of our response to the situation, we further ramped up our efforts to increase the presence of under-represented group members at the highest levels. Thus, we sought and found the ideal person to become Oaktree's first board member of color. **As previously announced, we were privileged last month to be able to attract Depelsha McGruder to join our board**. Howard University, Harvard MBA, 17 years as an executive at Viacom and presently COO and Treasurer of the Ford Foundation – this is an ideal background, especially given her role at Ford in managing global operations and vetting investment strategies to preserve and grow the $14+ billion endowment. We are excited to welcome Depelsha to our board and look forward to her contributions.

Environmental, Social and Governance – One of the biggest changes we've seen in the investment community in recent years is the increased attention to environmental, social and governance (ESG) considerations. Each year, more and more investors are increasing their emphasis on these matters and doing more about them by requiring investment managers to demonstrate their commitment. This has very much been reflected in the evolution of Oaktree's processes.

While we've long taken ESG considerations into account as part of our investment process, a decade ago we made little effort to document our ESG assessments. Moreover, each of our investment teams had its own ESG approach. In the last few years we formed an ESG Governance Committee to help improve and harmonize the ESG practices of our strategies globally. While we've made tremendous advances in ESG, to date we've done so without any dedicated resources. Given how fast the landscape is evolving, and because we've decided to redouble our commitment, we've created the position of full-time Head of ESG, reporting to our CIO and my co-chairman, Bruce Karsh.

I am pleased to report that we recently announced the appointment of Priya Prasad Bowe to that position. Priya, who joined Oaktree in 2019 to work on our credit businesses, has been integrally involved in the design and implementation of the ESG framework for our Global Credit strategy, including authoring the beginnings of its climate-change-management strategy. Going forward, Priya will work with all Oaktree investment teams to make certain we're fully aware and educated regarding emerging ESG risks and opportunities, and she will assist us in bolstering our ESG integration, documentation and engagement practices globally.

In addition to Priya, we're fortunate to have a deep bench of industry experts to provide guidance in this area, including our partners at Brookfield Asset Management. One such expert is Mark Carney, Brookfield's Vice Chairman and newly appointed head of ESG and Impact Fund Investing. Mark is the former Governor of the Bank of England and Bank of Canada and serves as a United Nations Special Envoy for Climate Action and Finance. Our investment personnel have begun to work with Mark to evolve their thinking on climate change. We expect over time to have much to report to you on ESG.

Oaktree Babies – It's one of my great pleasures each year to report on the progress of the Oaktree baby count. In that connection, 55 children were born to employees in 2020, bringing our since-inception performance to 831. I always take our employees' decision to bring a new person into this world as a show of their positive attitudes and faith in the future. **I'm particularly eager to see what 2021 brings in this regard, following the work-from-home stretch that began just over nine months ago**.

Positioning for 2021

Because the market is at a possibly critical juncture and its direction is much debated these days, I'm going to spend an unusual amount of time discussing positioning going forward. Thus, you might end up feeling this memo should have been titled *Preview of 2021* rather than *2020 in Review.*

Investors often imagine there are two distinct macro environments: times when the future is clear and times when it isn't. In reality, though, these periods are all pretty much the same, since perceived clarity regarding the future often turns out to have been illusory. Most macro forecasting consists of extrapolating current levels and recent trends with minor tinkering. While predictions of "no change" are often right – as continuation is the general rule – they give rise to little in terms of profit. Only forecasts of major deviation from trend can be highly profitable. But to be so, they also must be correct, and they rarely are. That's why profitable macro forecasts (and successful forecasters) are few and far between. This negative view on forecasting is a major theme running through Oaktree's culture and the reason we don't base our investments on macro forecasts.

Most investors felt that the beginning of 2020 was a time of clarity: the economy and the stock market were both expected to continue advancing. While everyone knew they wouldn't do so forever, nothing seemed poised to make them stop. And then came the strongest exogenous shock we've ever seen – the novel coronavirus – proving once again that we never know what's going to happen (and that even though we can't predict, we should prepare – more on this later). Today's environment, in contrast, seems to be characterized by a lack of clarity. Experts are expressing highly divergent opinions regarding the outlook for U.S. markets, with strong arguments both bullish and bearish.

Most important on the positive side of the ledger, we seem highly likely to have a healthy economy for a good while, and the Fed has telegraphed its plan for years of accommodative monetary policy to keep it that way. The economy continues to reopen and recover from the pandemic, and this process should speed up as the vaccine rollout accelerates. President Biden's administration wants to provide unprecedented levels of financial support and stimulus, and the Democrats probably have enough control of the two houses of Congress to do so.

I'm particularly impressed by the potential for well above average consumer spending. Think about all the things you didn't spend money on in the last 12 months, such as vacations, dinners out, concerts and shows, and clothing for special occasions, and about the millions of Americans of whom the same is true. Now consider the households that made more money last year than they did the year before – starting with those who received support checks but didn't suffer job losses. This caused real personal income to grow at the fastest rate in 20 years. **Harvard economist Jason Furman estimates that the combination of above-trend income and below-trend spending has created roughly $1.8 trillion of extra disposable personal income since the beginning of the pandemic**. Finally, add in the very positive wealth effect from last year's multi-trillion dollar appreciation on stocks and still more on homes.

The combination of this extra disposable income with the ending of a prolonged period of isolation and release of pent-up demand has the potential to add substantially to short-term economic growth. Many economists expect U.S. GDP to rise at a well above average rate this year, and with the early months likely to be slow, that implies big gains later in the year. Morgan Stanley, to pick one source, predicts that 4Q2021 annualized GDP will be 7.6% above 4Q2020. While the lockdown-related recession was painful, it set the stage for some very positive year-over-year comparisons in the period immediately ahead.

The strong economy will be abetted by a Fed that has promised to keep interest rates low for years and to continue buying bonds. The Fed will make every effort to keep monetary policy accommodative to support economic growth and job creation. It clearly demonstrated in the last year that its tools are varied and powerful, at least in the short run.

A related positive to consider is that market tops usually occur with the economy several years into the up-leg of the cycle and vulnerable to recession. This time, however, we have strong markets at the beginning of what may prove to be a long economic recovery. **The fact that we already see full asset prices so early in the recovery is a source of risk. But on the other hand, the fact that the economy is likely to grow for several years is very encouraging.**

Finally among the positives, I believe U.S. political uncertainty has declined somewhat, truncating the extreme tails of the distribution of possible events. With a center-left president and tiny Democratic majorities in both houses of Congress, I believe radical legislation is unlikely to be enacted.

Arrayed against the optimistic outlook regarding the two most important things, the economy and the fight against the pandemic, are a number of concerns. The shortest-term risk is the possibility of unimpressive first quarter GDP data. The latest severe wave of the virus, which took daily cases in the U.S. to record levels, may have slowed current economic activity (so far, the economic data are very mixed). But everyone knows this, and investors have been willing to "look across the valley" for the past eleven months and are unlikely to stop now, when strong growth is right around the corner.

The biggest risk of all is the possibility of rising interest rates. Rates have declined quite steadily for the last 40 years. This has been a huge tailwind for investors, since a declining-rate environment lowers the demanded returns on assets, making for higher asset prices. The linkage between falling interest rates and rising asset valuations is a good part of the reason why p/e ratios on stocks are above average and bond yields are the lowest we've ever seen (which is the same as saying bond prices are the highest).

But the downtrend in rates is over (if we can believe the Fed's assurance that it won't take nominal rates into negative territory). **Thus, while interest rates can rise from here – implying higher demanded returns on everything and thus lower asset prices – they can't decline. This creates a negatively asymmetrical proposition.**

So today's high asset prices may be justified at today's interest rates, but that's clearly a source of vulnerability if rates were to rise. (Note that today's 1.40% yield on the 10-year Treasury note is up from 0.52% at the low in August 2020 and from 0.93% in just the last seven weeks.)

The Fed says rates will be low for years to come, but are there limitations on its ability to make that happen? Can the Fed keep rates artificially low forever? On longer-maturity bonds? **And what about inflation? Can the 10-year Treasury note still yield 1.40% if inflation reaches 3%?** Will people buy it at a negative real yield? Or will the price fall so that it yields more? Where could inflation come from?

The price of goods may not rise in dollar terms, but reduced respect for the dollar (or increased quantities of dollars in circulation) could cause it to depreciate relative to the price of goods: same result.

On TV on February 7, Treasury Secretary Janet Yellen responded to a question about inflation risk posed by the proposed Covid-19 relief package with a long discourse on the importance of delivering relief to Americans who are suffering. Few would argue with that premise. She also made clear that she believes it's better to provide too much relief than too little. True as well. **But that doesn't mean (a) the more relief the better or (b) there aren't risks attached.** Experts from both sides of the political aisle have questioned whether the $1.9 trillion relief package under discussion is too much and/or misdirected; Larry Summers, a progressive economist, wrote to that effect in *The Washington Post* on February 4:

> . . . a comparison of the 2009 stimulus and what is now being proposed is instructive. In 2009, the gap between actual and estimated potential output was about $80 billion a month and increasing. The 2009 stimulus measures provided an incremental $30 billion to $40 billion a month during 2009 — an amount equal to about half the output shortfall.
>
> In contrast, recent Congressional Budget Office estimates suggest that with the already enacted $900 billion package — but without any new stimulus — the gap between actual and potential output will decline from about $50 billion a month at the beginning of the year to $20 billion a month at its end. The proposed stimulus will total in the neighborhood of $150 billion a month, even before consideration of any follow-on measures. That is at least three times the size of the output shortfall.
>
> In other words, whereas the Obama stimulus was about half as large as the output shortfall, the proposed Biden stimulus is three times as large as the projected shortfall. **Relative to the size of the gap being addressed, it is six times as large. . . .**
>
> Another [way of assessing the scale of a fiscal program] is to look at family income losses and compare them to benefit increases and tax credits. Wage and salary incomes are now running about $30 billion a month below pre-Covid-19 forecasts, and this gap will likely decline during 2021. Yet increased benefit payments and tax credits in 2021 with proposed stimulus measures would total about $150 billion — a ratio of 5 to 1. The ratio is likely even greater for low-income individuals and families, given the targeting of stimulus measures. . . .
>
> . . . while there are enormous uncertainties, **there is a chance that macroeconomic stimulus on a scale closer to World War II levels than normal recession levels will set off inflationary pressures of a kind we have not seen in a generation, with consequences for the value of the dollar and financial stability**. (Emphasis added)

Normally one would expect such a flood of additional liquidity into the economy to cause inflation to accelerate, but the Fed says no. Of course, although central banks might like to see inflation increase (as it makes it cheaper to repay debt), they have to discourage such talk for fear of fueling inflationary expectations. On the other hand, we've had substantial deficits and accommodative monetary policy ever since 2008 and no serious inflation. We've seen a 50-year-low in the unemployment rate and yet not the inflation the Phillips Curve would have predicted. And Japan and Europe have been trying for 2% inflation for years without success. Is inflation a threat anytime soon? The answer's clear: who knows?

In addition to these major risks, there are others that – although perhaps smaller, less consequential or less imminent – should nevertheless be considered:

- Optimism regarding the economy is based on positive assumptions about vaccines being efficacious, getting into arms, and holding up over time and against new variants. My own guess is that the U.S. will reach herd immunity in the third quarter, with life thereafter moving back in the direction of pre-pandemic norms. Disappointment regarding the speed or efficacy of vaccinations could delay and complicate the rekindling of economic growth.
- The actions of the Fed and U.S. Treasury may be leading investors to aggressively pursue high returns in today's low-return world, replacing risk aversion with risk tolerance. Signs that in the past indicated excessive optimism and complacency in stock and bond markets are present today:

    - the strong performance of speculative securities and "meme" stocks;
    - heavy retail buying of stocks, options buying, and buying on margin;
    - heated bidding for bond deals, low bond yields and weak contractual protections;
    - the Buffett Indicator (the ratio of total equity market capitalization to GDP) far above its previous high; and
    - large numbers of IPOs, including IPOs by unprofitable companies, and first-day share price jumps of tens or hundreds of percent.

- Since many investors have concluded over the last 20 years that they can't achieve the returns they want or need in traditional stocks and bonds, capital has flooded into alternative assets, complicating life for investors there, too.
- The unemployment rate may not soon fall to pre-Covid-19 levels, and the secular growth of the economy could remain unimpressive.
- U.S. relations with China are likely to continue to be thorny, flaring up from time to time, and globalization – with its economic benefits for the world overall – may be weaker than in the past.
- America's social and political divides are unlikely to close anytime soon, and the country may not easily resolve questions of unequal opportunity and treatment.

The above list omits two long-term worries that may seem theoretical and far off but I think are potentially significant:

- Can the Fed really increase its balance sheet by trillions of dollars and the U.S. run annual deficits in the trillions – in 2020 and in coming years – without negative consequences, like a decline in the dollar's value? If the dollar performs poorly, will it remain the world's reserve currency and leave unchanged the U.S.'s ability to borrow unlimited amounts of money to cover deficits? And what happens if the answer to that last question proves to be "no"?
- How will we find jobs for all the people who are displaced by technology and automation and lack the skills required to participate in the information economy? What happens to parts of the country that are left out of the new economy?

Finally, much of the worry about whether we're in a bubble relates to valuations. For the S&P 500, for example, the current ratio of price to projected 2021 earnings is roughly 22 (depending on which earnings estimates you use). This seems expensive compared to the historic average in the range of 15-16. But knee-jerk judgments based on the relationship between current valuations and historic averages are too simplistic to be dispositive. Before making a judgment about today's valuation of the S&P 500, one must consider (a) the context in terms of interest rates, (b) the shift in its composition in favor of rapidly growing technology companies, with their higher valuations, (c) the valuations of the index's individual components, including those tech companies, and (d) the outlook for the economy. **With these factors in mind, I don't think most of today's asset valuations are crazy**. Of course, a big correction in speculative stocks could have a negative impact on today's bullish investor psychology.

In particular, as to item (a) above, we can look at the relationship between today's 4.5% earnings yield* on the S&P 500 and the yield on the 10-year Treasury note of 1.4%. The implied "equity risk premium" of 310 basis points is very much in line with the average of 300 bp over the last 20 years. Valuations can also be viewed relative to short-term interest rates. The current p/e ratio on the S&P 500 of 22 is slightly below the reading of 24 in March 2000 (the height of the tech bubble), and the fed funds rate is around zero today versus 6.5% back then. Thus, in 2000, the earning yield on the S&P 500 was 4.2%, or 230 basis points below the fed funds rate, while today it's 450 bp above. In other words, the S&P 500 is much cheaper today relative to short-term rates than it was 21 years ago.

The story is similar in the credit market. For example, the yield spread on high yield bonds versus Treasurys is below the historic range, although probably still more than adequate to offset likely credit losses. Thus, as with most other assets today, the price of high yield bonds is high in the absolute, fair-ish in relative terms, and highly reliant on interest rates staying low.

So where does that leave us? In many ways, we're back to the investment environment we faced in the years immediately prior to 2020: an uncertain world, offering the lowest prospective returns we've ever seen, with asset prices that are at least full to high, and with people engaging in pro-risk behavior in search of better returns. This suggests we should return to Oaktree's pre-Covid-19 mantra: move forward, but with caution. But a year or two ago, we were in an economic recovery that was a decade old – the longest in history. Instead, it now appears we're at the beginning of an economic up-cycle that's likely to run for years.

Over the course of my career, there have been a handful of times when I felt the logic for calling a top (or bottom) was compelling and the probability of success was high. This isn't one of them. There's increasing mention of a possible bubble based on concerns about valuations, federal government spending, inflation and interest rates, but I see too many positives for the answer to be black-or-white.

In the interest of moving toward a conclusion, I'm going to briefly recap the pros, cons and counter-arguments:

- The **economic outlook** is positive, although Chairman Powell warns that the recovery remains "uneven and far from complete," with inadequate job creation.
- Thus he says the Fed will keep **interest rates** low for years. But with fiscal and monetary policy extremely accommodative, rates are already on the move up and vulnerable to increased inflation.
- **Inflation** stayed low in the 2010s despite records being set in terms of duration of the economic recovery, deficits and low unemployment. However, inflation's ability to remain so is uncertain.
- The **temperature of the market** is elevated, and there are signs of euphoria and risky behavior.
- **Valuations** are high relative to history, as security prices have run ahead of economic gains. High multiples are justified by today's low interest rates but dependent on continued low rates.
- **Risk compensation** is skimpy, as seen in the premium valuations of favored companies and in historically narrow yield spreads on credit.
- **Washington** poses a risk because of one party's control and the anti-capitalist policies of its most progressive members. My hope is that the narrow majorities render radical legislation less likely.
- As to **exogenous risks**, President Biden will pursue greater harmony, but tension with China and Iran and the racial and social divisions at home continue to cloud the outlook.

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* -- The earnings yield on a stock or stock index is the ratio of its earnings to its price. Thus it's the e/p ratio: the inverse of the p/e ratio, or 1 divided by the p/e ratio. A forward-looking p/e ratio of 22 equates to an earnings yield of 1 ÷ 22, or 4.5%.

With arguments on both sides, I feel the prices of most assets are in a gray area – certainly not low, mostly on the high side of fair, but not so high as to be unreasonable.

The bottom line is this: given current conditions, should investors be at their usual risk position, more defensive or more aggressive? **While the risk-adjusted returns of most asset classes seem to be at rough equilibrium relative to each other, all absolute returns are ultra-low, commensurate with today's equally low interest rates.** On balance, I think it's appropriate to be in one's normal stance, perhaps with a modest bias toward defense. Since the rewards for moving further out on the risk curve – such as yield spreads – aren't lavish, I have trouble seeing this as a time to aggressively chase high returns. **Moreover, the surer one is that rates will soon rise meaningfully, the more cautious one should be today.**

Because the primary risk lies in the possibility of rising inflation and the higher interest rates that would bring, I think portfolios have to make allowances: even though we can't predict, we should prepare. This possibility means (a) bonds with maturities much above ten years are obvious candidates for underweighting and (b) inflation beneficiaries should be considered for overweighting, including floating-rate debt, real estate capable of seeing rent increases, and the stocks of companies with the power to pass on price increases and/or the potential for rapid earnings growth.

When it comes to finding decent returns in this environment, the options are slim. Investors have plowed capital into the mainstream public "beta" markets. As a result, prospective returns have come down – fully reflecting the reduction in interest rates – and markets have become quite efficient. In most cases, price has converged with – if not run ahead of – intrinsic value. That means it's harder than ever to outperform, other than by taking on additional risk and being lucky enough to do so in an environment where such action is rewarded.

Although no markets are starved for capital these days, there may be alternative "alpha" markets where investment skill can add to returns, hopefully without a commensurate increase in overall risk. Some of this additional return is simply a premium for bearing illiquidity, and the pain suffered by some institutions during the 2008-09 crisis shows how important it is to correctly assess one's ability to live with illiquidity. And some of the return increment will come from employing managers with alpha, or the ability to add to return without a corresponding increase in risk. However, relying on positive alpha exposes investors to manager risk, or the possibility of hiring managers who turn out to have negative alpha.

This past year challenged many preconceived notions about the economy, markets and policy – and even changed the way we live. But the inescapable truth of investing remains unchanged: there is no magic answer, no solution (other than superior skill) that will enable an investor to earn a high return safely and dependably. And that's especially true in today's low-return world.

*   *   *

I wish you all the very best in 2021, and everyone at Oaktree looks forward to continuing our work together.

March 4, 2021

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The U.S. High Yield Bond – Broad Composite ("Composite") includes all actual, fully discretionary, fee-paying accounts that focus exclusively on the debt of solvent U.S. and Canadian corporations with an emphasis on senior, cash paying securities rated BB+ to CCC- and are benchmarked to the BB+/CCC- index.

The Oaktree Emerging Markets Equities performance results displayed herein represent the investment performance record for a composite of emerging markets long-only accounts managed by Oaktree. The Composite includes all fully discretionary accounts invested in the Emerging Markets Equity strategy.

The performance information set forth herein contains valuations of investments in companies that have not been fully realized as of December 31, 2020, or as otherwise noted. Oaktree values its investments in accordance with U.S. GAAP. Information regarding the valuation procedures and policies for each Oaktree fund, account or strategy mentioned herein is available upon request. There can be no assurance that any of these valuations will be attained as actual realized returns will depend upon, among other factors, future operating results, the value of the assets and market conditions at the time of disposition, any related transaction costs and the timing and manner of sale, all of which may differ from the assumptions upon which the valuations contained herein are based. Consequently, the actual realized returns may differ materially from the current returns indicated in this communication. Nothing contained herein should be deemed to be a prediction or projection of future performance. For more information or a description of the benchmark presented, please contact your Oaktree representative.

In addition, as noted herein, certain (but not all) of Oaktree's funds have utilized credit facilities (subscription lines), which has the effect of making fund, aggregate fund and composite level gross and net returns higher than the gross and net returns that would have been presented had drawdowns from partners been initially used to acquire the investment(s). There can be no assurance that future funds and strategies will be able to obtain comparable leverage on commercially reasonable terms.

Oaktree Performance

Important information about the statements: "When the markets fell sharply in March, our prior caution allowed 9 of our 14 open-end strategies to avoid part of their benchmarks' declines (before fees)." and "we're happy to report that 10 of the 14 strategies exceeded their benchmarks in the fourth quarter, allowing 9 of them to do so for the full year (all references to returns are before fees)."

The annual performance of the open-end strategies presented below is for the period of 1/1/2020 – 12/31/2020.

As of 12/31/20	Annual Gross Return		Annual Net Return	
Description	**Composite**	**vs. Benchmark**	**Composite**	**vs. Benchmark**
Global High Yield Bond (USD Hedged) Composite.	6.32%	0.76%	5.79%	0.23%
ICE BofA Non-Financial Developed Markets High Yield Constrained (USD Hedged)(1)	5.56		5.56	
Expanded High Yield Bond Composite	7.37	1.77	6.84	1.24
FTSE High-Yield Cash-Pay Capped (Local)(1)	5.60		5.60	
U.S. High Yield Bond - BB-B Composite	7.00	1.88	6.47	1.35
FTSE High-Yield Cash-Pay Capped, All BB/B - rated (Local)	5.12		5.12	
U.S. High Yield Bond - Broad Composite	7.39	1.79	6.85	1.25
FTSE High-Yield Cash-Pay Capped (Local)(1)	5.60		5.60	
European High Yield Bond (EUR Hedged) Composite	3.01	0.76	2.50	0.25
ICE BofA Global Non-Financial HY European Issuers Excluding Russia (EUR Hedged)	2.26		2.26	
U.S. Convertible Securities Composite	35.04	(11.18)	34.38	(11.84)
ICE BofA US Convertible Index (Local)(1)	46.22		46.22	
High Income Convertible Securities Composite	3.87	(2.42)	3.28	(3.01)
FTSE High-Yield Market (Local)	6.29		6.29	
Non-U.S. Convertible Securities (USD Hedged) Composite	15.23	5.89	14.66	5.32
Thomson Reuters Global Focus ex US Convertible Index (USD Hedged)(1)	9.34		9.34	
Global Convertible Securities (USD Hedged) Composite	24.81	1.97	24.20	1.36
Thomson Reuters Global Focus Convertible Index (USD Hedged)	22.84		22.84	
U.S. Senior Loan Composite	1.93	(0.85)	1.42	(1.36)
Credit Suisse Leveraged Loan (Local)	2.78		2.78	
European Senior Loan (EUR Hedged) All-Currency Composite	2.54	0.16	2.02	(0.35)
Credit Suisse Western European Leveraged Loan (EUR Hedged)	2.38		2.38	
Global Credit Composite	3.91	(0.38)	3.24	(1.05)
CUST-GLOBALCREDIT(1)	4.29		4.29	
Emerging Markets Equity (MSCI) Composite	16.56	(1.75)	15.64	(2.67)
MSCI Daily TR Net Emerging (USD Unhedged)	18.31		18.31	
Global Credit Fund-OAR	6.16	5.49	5.74	5.07
ICE BofA 3-Month U.S. Treasury Bill	0.67		0.67	
	Out Performed	**9**	**Out Performed**	**8**
	Total Count	**14**	**Total Count**	**14**

The performance of the open-end strategies presented below is for the period of 10/1/2020 – 12/31/2020.

As of 12/31/20	Annual Gross Return		Annual Net Return	
Description	**Composite**	**vs. Benchmark**	**Composite**	**vs. Benchmark**
Global High Yield Bond (USD Hedged) Composite.	6.40%	0.13%	6.27%	0.00%
ICE BofA Non-Financial Developed Markets High Yield Constrained (USD Hedged)(1)	6.28		6.28	
Expanded High Yield Bond Composite	6.54	0.27	6.41	0.14
FTSE High-Yield Cash-Pay Capped (Local)(1)	6.27		6.27	
U.S. High Yield Bond - BB-B Composite	5.84	0.21	5.71	0.08
FTSE High-Yield Cash-Pay Capped, All BB/B - rated (Local)	5.63		5.63	
U.S. High Yield Bond - Broad Composite	6.29	0.02	6.16	(0.11)
FTSE High-Yield Cash-Pay Capped (Local)(1)	6.27		6.27	
European High Yield Bond (EUR Hedged) Composite	4.94	(0.36)	4.81	(0.49)
ICE BofA Global Non-Financial HY European Issuers Excluding Russia (EUR Hedged)	5.30		5.30	
U.S. Convertible Securities Composite	15.92	(3.75)	15.78	(3.89)
ICE BofA US Convertible Index (Local)(1)	19.67		19.67	
High Income Convertible Securities Composite	7.10	0.65	6.95	0.50
FTSE High-Yield Market (Local)	6.45		6.45	
Non-U.S. Convertible Securities (USD Hedged) Composite	9.69	2.75	9.56	2.61
Thomson Reuters Global Focus ex US Convertible Index (USD Hedged)(1)	6.95		6.95	
Global Convertible Securities (USD Hedged) Composite	12.86	2.14	12.73	2.00
Thomson Reuters Global Focus Convertible Index (USD Hedged)	10.72		10.72	
U.S. Senior Loan Composite	3.38	(0.26)	3.25	(0.39)
Credit Suisse Leveraged Loan (Local)	3.64		3.64	
European Senior Loan (EUR Hedged) All-Currency Composite	3.44	(0.10)	3.31	(0.23)
Credit Suisse Western European Leveraged Loan (EUR Hedged)	3.54		3.54	
Global Credit Composite	5.91	0.94	5.74	0.77
CUST-GLOBALCREDIT(1)	4.98		4.98	
Emerging Markets Equity (MSCI) Composite	24.67	4.97	24.43	4.74
MSCI Daily TR Net Emerging (USD Unhedged)	19.70		19.70	
Global Credit Fund-OAR	0.88	0.85	0.78	0.75
ICE BofA 3-Month U.S. Treasury Bill	0.03		0.03	
	Out Performed	**10**	**Out Performed**	**8**
	Total Count	**14**	**Total Count**	**14**

Oaktree Power Opportunities Fund IV – Preqin Record
Important information about the statement: "we believe Power Fund IV's performance makes it the highest returning fund of its size in U.S. private equity history"

The source for this information originates from Preqin, an independent alternative assets data collection and reporting service. Their 12/31/2020 report includes data and return information on Preqin's U.S. Private Equity fund universe starting from 1985 of 126 funds in the $1billion to $1.3billion fund size.

The representative metric is based on the funds' Multiple on Invested Capital ("MOIC")

Fund and Vintage Year	*Net IRR*	*MOIC*	*Date Reported*
*Oaktree Power Opportunities Fund IV (2016)**	*8.12*	*1.32*	*6-30-2020*
- *Fund IV (Source: Oaktree)*	*56*	*4.6*	*1-31-2021*
*OCM/GFI Power Opportunities Fund II (2005)**	*58.80*	*3.66*	*12-31-2020*
*Other Private Equity fund (1987)**	*28.85*	*4.49*	*12-31-2020*

** Source: Preqin 12/31/20 Private Equity Fund Report.*

The 12/31/20 Preqin report does not reflect the current performance data of Power Fund IV. However, based on Oaktree's current data, Power Fund IV's MOIC is 4.6 as of January 31, 2021, reflecting its position as the highest performing U.S. private equity fund based on MOIC.

Further, please note we understand that you appreciate that such performance comparisons are difficult to prepare fairly. Meaningful comparisons require access to accurate data and appropriate consideration of strategy, vintage and leverage (in addition to myriad other factors). Unfortunately, we don't always have access to all of the requisite data of our competitors. Thus, while we are sharing this data that we rely upon internally, we want to be sure you understand the limits of our analysis.

As the Preqin database purports to report accurate performance data (though we are obviously not in a position to verify the data they report). The analysis provided herein is derived from that data. Needless to say, our analysis is inherently subjective. Among other things, you might question whether we have appropriately selected our competitors. Due to the limitations of the data we cannot guarantee that the competitive analysis or the investment universe provided herein is fully comparable. Moreover, we are subject to the limitations of the underlying data, which does not always include IRR or other information that might be meaningful to a competitive assessment. In addition, the information presented also does not disclose the investment objectives, risks, fees, or tax features of the peer funds included in the comparison universe, all of which is relevant information for a full comparison. Nevertheless, it is our best attempt to compare our performance and we make it available to you in that spirit and in the hope that you will find it helpful.

Calculation of Assets Under Management
References to total "assets under management" or "AUM" represent assets managed by Oaktree and a proportionate amount of the AUM reported by DoubleLine Capital LP ("DoubleLine Capital"), in which Oaktree owns a 20% minority interest. Oaktree's methodology for calculating AUM includes (i) the net asset value (NAV) of assets managed directly by Oaktree, (ii) the leverage on which management fees are charged, (iii) undrawn capital that Oaktree is entitled to call from investors in Oaktree funds pursuant to their capital commitments, (iv) for collateralized loan obligation vehicles ("CLOs"), the aggregate par value of collateral assets and principal cash, (v) for publicly-traded business development companies, gross assets (including assets acquired with leverage), net of cash, and (vi) Oaktree's pro rata portion (20%) of the AUM reported by DoubleLine Capital. This calculation of AUM is not based on the

definitions of AUM that may be set forth in agreements governing the investment funds, vehicles or accounts managed and is not calculated pursuant to regulatory definitions.

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Memo to: Oaktree Clients

From: Howard Marks

Re: Thinking About Macro

> For a piece of information to be desirable, it has to satisfy two criteria: it has to be important, and it has to be knowable. – Warren Buffett

Regular readers of my memos know that Oaktree and I approach macro forecasts with a high degree of skepticism. In fact, one of the six tenets of Oaktree's investment philosophy states flatly that we don't base our investment decisions on macro forecasts. Oaktree doesn't employ any economists, and we rarely invite them to our offices to share their views.

The reason for this is simple: to use Buffett's terminology, we're convinced the macro future isn't knowable. Or, rather, macro forecasting is another area where – as with investing in general – it's easy to be as right as the consensus, but very hard to be more right. Consensus forecasts provide no advantage; it's only from being more right than others – from having a knowledge advantage – that investors can expect to dependably earn above average returns.

Many investors think their job requires them to develop a macro outlook and invest according to its dictates. Successful stock pickers or real estate buyers often make pronouncements regarding the macro outlook, even in the absence of evidence linking their investment success to accurate macro forecasts. Nonetheless, since macro developments are so influential, many people think it's downright irresponsible to ignore them when investing. Yet:

- Most macro forecasts are likely to turn out to be either (a) unhelpful consensus expectations or (b) non-consensus forecasts that are rarely right.
- I can count on one hand the investors I know who successfully base their decisions on macro forecasts. The rest invest from the bottom up, one investment at a time. They buy when they think they've found bargains and sell things they consider overpriced – mostly without reference to the macro outlook.
- **It may be hard to admit – to yourself or to others – that you don't know what the macro future holds, but in areas entailing great uncertainty, agnosticism is probably wiser than self-delusion.**

But why take my word for it? How about these authoritative views?

> 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. – Amos Tversky

> 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. – Mark Twain

That brings me to the subject of forecasters' track records, or rather the lack thereof. Back in the 1970s, an elder told me, "an economist is a portfolio manager who never marks to market," and that description still seems highly appropriate. Have you ever heard an economist or macro strategist say, "I think there'll be a recession soon (and xx% of my recession predictions have turned out to be right within a year)"? Would anyone invest with an investment manager who didn't publish a track record? Why follow macro forecasters who don't disclose theirs?

Finally, I want to point out that the same comments apply to most investors. You rarely hear them say they have no idea what the macro future holds or beg off from expressing opinions. One of the most important requirements for success in investing is self-assessment. What are your strengths and weaknesses? If you invest on the basis of your macro views, how often have they helped? Is it something you should keep doing or discontinue?

Having gotten everything off my chest concerning the shortcomings of forecasts, I'm going to devote the rest of this memo to thinking about the future. Why? To invert the Buffett quote that began this memo, the macro future may not be knowable, but it certainly is important. When I think back to the years leading up to 2000, I picture a market that largely responded to events surrounding individual companies and stocks. Since the Tech Bubble burst in 2000, however, the market has appeared to think mostly about the economy, the Federal Reserve and Treasury, and world events. That's been even more true since the Global Financial Crisis in 2008. **That's why I'm devoting a memo to a subject I largely disavow.**

I'll try below to enumerate the macro issues that matter, discuss the outlook for them, and end with some advice regarding what to do about them. That reminds me to put forth my conviction that we all have views about the future, but as we say at Oaktree, **"It's one thing to have an opinion, but something very different to assume it's right and bet heavily on it." That's what Oaktree <u>doesn't</u> do.**

<u>Inflation</u>

As of this writing, macro considerations are certainly in the ascendency, centering on the subject of inflation. Over the last 16 months, the Fed, Treasury and Congress have used a firehose of money to support, subsidize and stimulate workers, businesses, state and local governments, the overall economy and the financial markets. This has resulted in (a) confidence in the prospects for a strong economic recovery, (b) skyrocketing asset prices, and (c) fear of rising inflation.

The policy measures described above traditionally would be expected to produce the following:

- a stronger economy than would otherwise have been the case;
- higher corporate profits;
- tighter labor markets and thus higher wages;
- more money chasing a limited supply of goods;
- an increase in the rate at which the prices of goods rise (i.e., higher inflation); and, eventually,
- a tightening of monetary policy to fight inflation, resulting in higher interest rates.

While the functioning of economies is highly variable and uncertain, economic orthodoxy considers the above process about as reliable as they come. However, I want to take a minute to highlight the uncertainty entailed in thinking about inflation.

- Among the defining elements that marked my early years in investing was the 5-15% annual inflation that prevailed in the U.S. from the early 1970s through 1982. Dr. Doom and Dr. Gloom (chief economists Henry Kaufman of Salomon Brothers and Al Wojnilower of First Boston – I forget which was which) regularly admitted in their depressing speeches that they weren't sure what was causing the inflation or how to bring it down. No one was able to make progress combatting inflation until Fed Chair Paul Volcker solved the problem by raising interest rates dramatically, bringing on a significant double-dip recession in 1980-82.
- What about the more recent experience? For years, central bankers in the U.S., Europe and Japan have targeted a healthy 2% rate of inflation, but none of them have been able to produce it. This despite continuous economic growth, significant budget deficits, rapid expansion of the money supply through quantitative easing, and low interest rates – all of which are supposed to be inflationary.
- Finally, for roughly the last 60 years, economists have trusted the so-called Phillips Curve, which posits an inverse relationship between unemployment and inflation: the lower the unemployment rate, the tighter the labor market, the more negotiating power workers have, the more wages rise, and the greater the increase in the prices of consumer goods. But the U.S. unemployment rate fell throughout the last decade – ultimately hitting a 50-year low – and still there was no material increase in inflation. Thus, few people talk about the Phillips Curve anymore.

The low reported U.S. inflation rates may be partially attributable to changes in recent decades in the way the Consumer Price Index is calculated, but the truth is that we know very little about inflation, including its causes and cures. I describe it as "mysterious," so I believe we should put even less stock in predictions surrounding inflation than in other areas. **That makes life tough for investors at the moment, because inflation and its impact on interest rates constitute the most important wildcards.**

Inflation Outlook Today

There's been a great deal written about the current prospects for inflation, and rather than rehash it fully, I'll deliver a brief summary. Here's the background:

- To support the economy and its participants during last year's Covid-19-related shutdown, the Fed, Treasury and Congress took drastic action to prevent a global slowdown that could have rivalled the Great Depression.
- They injected trillions of dollars of liquidity into the economy in the form of benefit payments to individuals, loans and grants to businesses and governments, enhanced unemployment insurance and large-scale bond buying. In fact, I think of 2020 as the year the word "trillions" came into everyday use.
- Many people made more money in 2020 than they did in 2019, thanks to the enhanced benefits. 2020's above-trend incomes coincided with below-trend spending, as we couldn't take vacations or spend money on dinners, concerts, weddings, etc. The combination of these developments is estimated to have added roughly $2 trillion to consumer balance sheets.

- The Fed/Treasury actions flooded the financial markets with money, driving strong price increases and the reopening of the capital markets. The wealth effect – from stock market gains totaling in the double-digit trillions of dollars, plus soaring home prices – was significant; this dwarfed the positive impact on consumer balance sheets of higher incomes and lower spending.

The following signs suggest we may be headed for a significant period of higher inflation:

- All the things described immediately above would normally be expected to result in accelerating inflation.
- Concern about rising inflation in the next few years has been a topic of elevated discussion. Initially these anxieties were based simply on economic theory, but in 2021 they've been supported by empirical evidence:
  - Used car prices rose dramatically because of shortages of imported parts.
  - Home prices skyrocketed.
  - Materials and component prices escalated: e.g., copper, lumber and semiconductors.
  - Smartphones were in short supply.
- Shortages of labor in certain sectors have added to the threat of rising prices.
- The year-over-year increase in the Consumer Price Index was 4.2% in April, 5.0% in May and 5.4% in June. These are the highest readings since September 2008.
- Not only might higher prices for inputs ("cost-push" inflation) and more dollars chasing goods ("demand-pull" inflation) result in an excess of demand over supply and thus rising inflation, but excessive money printing might reduce the demand for U.S. dollars, cutting the currency's value and causing the dollar prices of imports to the U.S. to rise.
- Particularly troubling in this regard is the recent tendency of those in Washington to spend trillions of dollars without identifying solid "pay-fors." This has coincided with the rising influence of Modern Monetary Theory, which essentially says deficits and debt don't matter. What if these ideas are ill-founded?

On the other hand, here are the arguments for why higher inflation might prove "transitory" (the word *du jour*).

- Many of the shortages affecting finished goods and manufacturing inputs – and the resultant price increases – can be seen as a natural consequence of restarting the economy and, especially, the global supply chain. **It's unrealistic to expect all parts of the global economy to immediately resume efficient functioning**, and a lack of a single part can cause significant disruption, making it hard to manufacture finished goods. Since these factors result from the restart, they may prove ephemeral.
- It should be borne in mind that the prices of raw materials or finished goods aren't solely determined by current economic developments in a direct, mechanical way, meaning prices aren't necessarily "right" given prevailing conditions, any more than stock prices are always right. Rather, prices of goods are influenced by economic participants' psyches and can easily overshoot or undershoot (just as in the stock market). As John Mauldin wrote in *Federal Reserve Folly* (July 23, 2021), "The rising prices that add up to inflation are the result of producer and consumer *expectations* for the future." **Thus prices aren't just the result of supply and demand today, but also an indication of what people think prices**

will be in the future. We see this in the price of lumber, which rose by roughly 540% between the low in April 2020 – when no one thought there would ever be demand for new homes – and the high in May 2021 – when no one thought the supply of homes could ever meet the demand. Now the price of lumber is down by more than 60% in just the last two months, and we no longer hear much about its contribution to inflation.

- Clearly, a lot of the inflation seen in the first half of 2021 can be attributed to increased consumer spending financed by Covid-19 relief and the resultant bulge in savings and wealth. This should prove temporary: a given pool of extra dollars can't produce elevated spending forever.
- The ending of enhanced unemployment benefits in September should bring more workers into the job market, reducing the impact of labor shortages on wages and thus the prices of goods.
- The growth of the economy will undoubtedly slow after 2021 or 2022, by which time the impact of 2020's pent-up consumer demand will ebb significantly.
- There's hope that the recent levels of stimulus, deficit spending and money printing will recede in the next few years (or at least their rate of growth will slow) as the economy continues to expand, meaning these factors will decline relative to the size of the economy.
- Technology, automation and globalization are likely to continue to have significant deflationary effects.

The debate rages on regarding whether today's inflation will prove permanent or transitory. There's a great deal riding on the answer since higher inflation would doubtless lead to higher interest rates and thus lower asset values. **But in my view, it's impossible to know the answer. (There you have it: important, but not knowable.)** There are intelligent people on both sides of the argument, but I'm convinced there's no such thing as "knowing" what the outcome will be.

What Does the Fed Know?

The Fed is responsible for keeping inflation under control (among its other jobs). However, Fed leaders admit that they're not highly confident regarding their expectations. Here's what Fed Chair Jerome Powell said in a June 16, 2021 press conference (emphasis added):

> **So I can't give you an exact number or an exact time**, but I would say that we do expect inflation to move down. If you look at the forecast for 2022 and 2023 among my colleagues on the Federal Open Market Committee, you'll see that people do expect inflation to move down meaningfully toward our goal. And I think that the full range of inflation projections for 2023 falls between 2% and 2.3%, which is consistent with our goals.

At roughly the same time, St. Louis Federal Reserve Bank President James Bullard also spoke about the uncertainty that's present:

> Mr. Bullard . . . said the U.S. economy "is in an environment where we've got a lot of volatility, **so it's not at all clear that any of this will pan out the way anybody's talking about**." (*The Wall Street Journal*, June 18, emphasis added)

This is the kind of candid speech we need. **But it's clear from the above that we can't conclude "we have the answer" on the subject of inflation . . . or even that there is "an answer."**

What Does the Market Know?

The stock market started off 2016 with a big decline, which seemed to me to be irrational. As a result, I wrote a memo saying the market needed a trip to a psychiatrist (*On the Couch*, January 14, 2016). The next day, when I went on TV to discuss that memo, I was pressed on whether the stock market's decline foreshadowed something dire. "No," I said: the market doesn't "know" much about the future that we don't collectively know. That inspired me to write another memo five days later with the same title as this section: *What Does the Market Know?* (January 19, 2016). What is it telling us today?

In recent months, signs of rapidly rising inflation have been everywhere, and the media have tied the occasional stock market dips to inflation fears. For example, the S&P 500 Index experienced a moderate decline for the 10 trading days ending on June 18. Here's what *The Wall Street Journal* had to say the next day:

> U.S. stocks retreated Friday, as traders warily eyed the Federal Reserve for hints of where monetary policy is headed.
>
> The Dow Jones Industrial Average had its worst week since the week ended Oct. 30. The index of blue-chip stocks on Friday fell 1.6%, or 533.37 points, to 33290.08. For the week, it lost 3.45%.
>
> The S&P 500 declined 1.3%, or 55.41 points, to 4166.45 on Friday, losing 1.9% on the week. That broke a three-week streak of gains. The Nasdaq Composite lost 0.9%, or 130.97 points, to 14030.38, as large technology stocks also fell. For the week, it was down 0.3%.
>
> Policy makers had signaled Wednesday that they expect to raise interest rates by late 2023, sooner than they had previously anticipated. Sentiment waned again on Friday after Federal Reserve Bank of St. Louis leader James Bullard said on CNBC that he expects the first rate increase even sooner, in late 2022. . . .
>
> It isn't surprising that equities are falling, said ThinkMarkets analyst Fawad Razaqzada. U.S. stocks have hit a series of record highs and have been outpacing the economic recovery since last year. Now traders are repricing that "reflation trade" as they watch the Federal Reserve slowly start to alter its stance on monetary policy.
>
> "It was coming," he said. "This kind of selloff was coming because the market got ahead of itself."
>
> The Cboe Volatility Index, known as Wall Street's "fear gauge," climbed to its highest level in weeks.

> "The markets will be more spooked by 2022 turning to a rate hike, because that will mean they have to taper as well," said Derek Halpenny, head of research for global markets in the European region at MUFG Bank. (*The Wall Street Journal*, June 19)

As usual, media commentators stand ready to explain in a logical fashion why the markets did what they did (I always wonder where they look to get the explanation). They're also glad to tell us what that means for the future, invariably through extrapolation.

Regardless, the theme thus far in 2021 has been rising inflation. That and the associated fear of higher interest rates have been used to explain much of what's been going on in the stock market. The data reflected rapidly rising inflation, and stock market investors turned negative.

So far, so good. You might say the stock market was efficiently reflecting developments and the outlook. But the bond market didn't see it the same way:

> In bond markets, the yield on the 10-year Treasury note fell to 1.449% Friday, down from 1.509% Thursday. The 10-year yield has fallen for five straight weeks . . .
>
> Consumer prices paid by city dwellers in the U.S. rose more than 7% [in May] and more than 9% in April on an annualized basis. If this keeps up the rest of the year, it will be the highest inflation rate the U.S. has experienced since the 1980s. But fear not, say some investors and the Federal Reserve, the bond market isn't worried. Yields fell over the last week and remain low by historical levels, even after rising on the back of [Fed Chair] Jay Powell's speech Wednesday. And if markets aren't worried, maybe we shouldn't be either. . . . (Allison Schrager, senior fellow at the Manhattan Institute, *Bloomberg Opinion*, June 18)

The stock market was afraid of higher inflation and interest rates, but the bond market – where price movements are governed predominantly by the outlook for rates – gave us higher prices and lower rates, seemingly unconcerned about inflation.

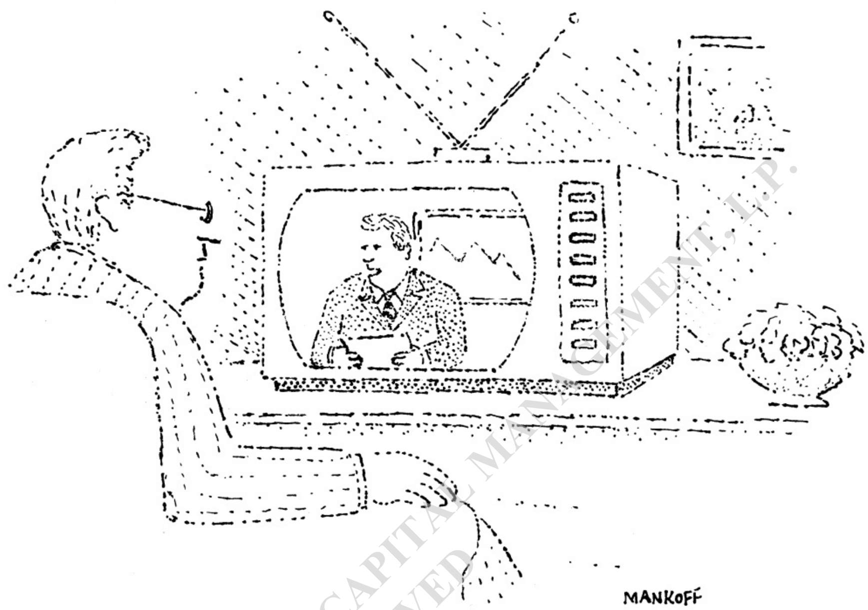
That brings me to gold, which historically has been bought for protection against inflation. Despite all the inflationary signs, the market for gold seems to agree with the bond market that the outlook for inflation is benign.

> Gold futures fell 0.3%, adding to their losses from Thursday, when they suffered their largest drop in over 10 months. For the week, gold fell 5.8%, its worst one-week performance since the week ended March 13, 2020. (*The Wall Street Journal*, June 19)

The price of gold hit an all-time high of $2,067 per ounce on August 6, 2020, likely driven by the Fed's enormous injection of money into the economy and markets. And then, on June 18, 2021, when concern about inflation seemed to be rising, it hit $1,773, down 14% from the high reached 10 months earlier. (Gold prices from Goldhub)

So in June we had bouts of stock market weakness, reportedly on inflation fears, and rising bond prices (declining yields), seemingly based on bond buyers' conviction that economic weakness will keep inflation subdued. And we saw gold, the classic anti-inflation tool, marked down just as stock market investors were described as being concerned about inflation. **Not only do the markets not know what's coming, but they often behave in ways that make little or no long-term sense.**

I concluded my 2016 memo *What Does the Market Know?* by saying that, on the subject of when to buy and sell securities, "the market has nothing useful to contribute." I think we can say the same about what it knows about future macro events. Perhaps the market's thought process is best understood through this old cartoon – one of the greatest of all time – which I included in *On the Couch*.



"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."

Markets function like highly sensitive instruments, absorbing events and publishing their reaction, be it bullish or bearish. **While markets are usually good "observers," hyper-attuned to current developments, they sometimes seem to view events through either a positive or a negative lens (and to oscillate between the two), as shown above. Further, they're rarely good "predictors," in the sense of knowing what comes next.**

Because their reaction to short-run developments tends toward excess, the markets provide a lot of false positives and negatives regarding their significance. But the fact that markets can overemphasize current developments and fail to look far enough into the future doesn't mean they should be ignored entirely. In particular, when security prices perform differently than what we would expect based on our views, we should consider whether the market has discerned something that throws our prior understanding into question. (Are the markets capable of exceptional insight? Check out the S&P 500's 68% gain from its low on March 23 through the end of 2020, which "no one" thought made sense when it began. The markets certainly did a much better job of recognizing the potential impact of the Fed/Treasury actions than did most commentators.)

What Do the Forecasters Know?

Although it's on the subject of stock market returns rather than inflation, I can't fail to share some data regarding forecasts supplied by Sheldon Stone, my longest-running partner (we just passed 38 years working together). Last December, he shared a *New York Times* article by Jeff Sommer entitled "Clueless About 2020, Wall Street Forecasters Are at It Again for 2021" (December 18, 2020). According to the article:

In December 2019, the median forecast on Wall Street held that the S&P 500 would rise 2.7% in 2020. Since the actual return on the index was 18.4%, that forecast was too low by 16 percentage points. But in April 2020, after the pandemic had taken hold (and after the initial actions on the part of the Fed, Treasury and Congress had been announced and initiated), the consensus forecast return was revised downward to negative 11% – **almost 30 percentage points below the eventual outcome**.

Obviously, nobody could have been expected to have predicted the pandemic. Ditto for the full success of the policy response or the timing and extent of the consequent market bounce. But Sommer shared longer-term data from Paul Hickey, co-founder of Bespoke Investment Group, which is more meaningful. I'll mostly use Sommer's words to convey the facts:

- Since 2000, the median analyst forecast has called for an average yearly return on the S&P 500 of 9.5%, whereas the actual average gain was 6.0%. You might say, "not bad, only off by 3.5 percentage points." Or you might say, "terrible – the forecasters overestimated the average gain by 58% (9.5/6.0 - 1)."

- "Each December since 2000, **the median forecast never called for a stock market decline** over the course of the following calendar year . . ." (emphasis added). And yet the stock market lost money in **six** of those years.

- "In 2018, for example, the market fell 6.9 percent, though the forecasters said it would rise 7.5 percent, a spread of 14.4 percentage points. In 2002, the forecast called for an increase of 12.5 percent, but stocks fell 23.3 percent, a spread of almost 36 percentage points."

- "All told, when gaps like that are taken into account, the median Wall Street forecast from 2000 through 2020 missed its target by an average 12.9* percentage points — which was more than double the [6.0%] actual average annual performance of the stock market. Year after year, these forecasts are about as accurate as those of a weatherman who always calls for balmy sunshine in a city where it rains or snows about 30 percent of the time. Some forecasts!" (* What accounts for the difference between the average error of 3.5 percentage points cited in the first bullet point and this 12.9? I assume the latter to be the average of the "absolute value" of the error. When you think in terms of absolute value, being too high by 3% in year one and then too low by 2% in year two means the absolute values of the errors add up to 5%, rather than netting out to only 1%.)

The bottom line is that hundreds or perhaps thousands of people make their living as professional market forecasters, despite the fact that the median forecast is of no value: wrong on average, positive in good years and bad, and **way off target when an accurate forecast would have been most profitable**.

The Role of the Fed

A great deal of the current debate over the macro outlook surrounds the Fed and its policies and behavior. In March 2020, the Fed triggered the recovery we're enjoying by cutting the key federal funds rate to 0-0.25%, initiating loan and grant programs, and buying vast amounts of bonds. This combination was very successful, producing powerful recoveries in the economy and the financial markets. However, the same actions helped create the threat of persistently higher inflation.

The Fed has two primary assignments: (a) making sure the economy grows enough to create jobs, leading to full employment, and (b) keeping inflation under control. To some extent, these tasks are in conflict. **Stronger economic growth risks overheating and inflation. Higher inflation leads investors to demand higher interest rates to more than compensate for the loss of purchasing power. Higher interest rates threaten to slow the economy.**

The economic outlook turned positive last summer in response to the Fed/Treasury actions and then was further bolstered by the success of vaccines. Thus, we're seeing strong economic growth – real GDP rose at an annualized rate of 6.4% in the first quarter – and expectations remain high for the rest of 2021 and perhaps 2022. Yet, the Fed continues to hold interest rates near zero and buy $120 billion of bonds per month. **Why stimulate an economy that's doing so well, and run the risk of inflation?**

In fact, the Fed seems to be relatively unworried about inflation. At first it said it didn't think there would be inflation (recent data has disproved that). Then it said if there is inflation, it will be transitory. And the Fed went on to say if inflation appears to be other than transitory, they have the tools with which to fight it.

By maintaining its high level of accommodativeness, the Fed is showing that it's more worried about economic sluggishness than about inflation. One informed observer told me that if growth falls back to the recent norm of 2% or less despite all the stimulus that's been thrown at the economy, the Fed feels we risk serious stagnation. And let's remember that (a) ever since the turn of the century there has been slow GDP growth and serious discussion of "secular stagnation" and (b) while the economic recovery from 2009 through 2019 was the longest in history, it was also the slowest since World War II.

Fed Chair Powell's recent testimony shows how he prioritizes the considerations, several months into the recovery:

> Federal Reserve Chair Jerome Powell on Wednesday pledged "powerful support" to complete the U.S. economic recovery from the coronavirus pandemic . . .
>
> In testimony to the U.S. House of Representatives Financial Services Committee, Powell said he is confident recent price hikes are associated with the country's post-

pandemic reopening and will fade, and that the Fed should stay focused on getting as many people back to work as possible.

> Any move to reduce support for the economy, by first slowing the U.S. central bank's $120 billion in monthly bond purchases, is "still a ways off," Powell said, with 7.5 million jobs still missing from before the pandemic. (*Reuters*, July 14)

But even if economic sluggishness is the greater risk – and who's to disagree with the Fed and insist it's not – the risk of inflation is still real, as would be the consequences. I'm sure we're all much better off with the Fed possibly overshooting on stimulus, rather than undershooting. And I believe the Fed was right to do all it did despite the possibility of negative ramifications. Still, we must consider those ramifications.

- Higher inflation could lead to higher interest rates as investors demand positive real yields, but also if tighter monetary policy and higher rates are employed to fight the inflation.
- Higher interest rates could negatively affect the economy.
- Higher interest rates make investors demand higher returns, leading to lower prices for financial assets and the possibility of a market collapse (see 1972-82).
- Higher inflation would hit low-income Americans the hardest, since they spend the lion's share of their incomes on necessities, and threaten the lifestyle of the millions of retirees and others on fixed incomes.
- Higher interest rates would raise the cost of servicing the national debt, further swelling the annual deficits (and therefore the national debt).
- Larger deficits could make lenders (and foreign buyers) demand still-higher interest rates on U.S. debt securities, creating a negative feedback loop.
- If we continue to print enough money to pay the interest and fund the deficit, eventually the value of the dollar and its use as the world's reserve currency could be called into question.
- As we've experienced in the past, rapidly rising prices could cause inflationary expectations to become embedded in Americans' psyches, making the increases self-perpetuating and hard to combat.

Further, we should consider the negative aspects of accommodative monetary policy itself:

- Fed largesse can be viewed as implying the existence of a "Fed put," or a guarantee of future bailouts. The consequences can include increased moral hazard (the belief that investors can take risk without consequences) and a diminution of the risk aversion that must be present in order for markets to be safe.
- The above conditions can lead businesses and investors to use more leverage, magnifying the potential damage from a slowdown.
- As we've seen in the last 16 months, the Fed can't stimulate the economy without increasing the value of the economy. And who receives the benefit? The people who own the economy (i.e., the owners of equities, companies and real estate). Thus, stimulus and the resultant asset appreciation exacerbate the disparity in wealth, which is receiving increased consideration.
- If the Fed maintains its current level of accommodation – including keeping interest rates near zero – it will have relatively few levers to pull in case a future slowdown calls for incremental stimulus. For example, cutting interest rates was a key part of last year's rescue

package. This wouldn't have been possible if rates had been at zero when the Fed first took action.

Some people wonder whether the Fed might produce perpetual prosperity, preventing recessions or minimizing them as it did last year. Some hope low interest rates can keep markets aloft forever. Some think the Treasury can issue as much debt as is needed, with the Fed willing to step in as the buyer of last resort. Obviously, a lot of people in the federal government think unlimited sums can be spent without negative consequences from the resulting increased deficits and debt.

I'm not smart enough to prove it, but to me these assumptions seem too good to be true. They have the appearance of a perpetual motion machine or a credit card with no credit limit and no requirement to pay off the balance. **I can't tell you exactly what the catch is, but I think there has to be one. Or, perhaps better put, I wouldn't bet the ranch on there <u>not</u> being a catch.**

In the 1930s, John Maynard Keynes suggested that nations should run fiscal deficits in times of weakness to stimulate demand, reenergize their economies, and create needed jobs. It's not for nothing that deficit spending is described as "Keynesian." But even Lord Keynes asserted that while deficits are a reasonable way to jumpstart a sluggish economy, governments should run surpluses in times of prosperity and use them to repay the debts incurred in times of weakness. However, in the 21st century, concepts like fiscal discipline, budget surpluses and debt repayment seem to have gone out the window.

The U.S. has run large and growing deficits for more than 20 years, and that seems less likely than ever to change. Traditional economics asserts that this will be inflationary, but as mentioned earlier, the deficits of the 2010s didn't bring on substantial inflation. Perhaps they merely helped support an economy that would have been even weaker in their absence.

Regardless, we've now entered into a time of testing. As I said earlier, in 2020, we saw trillions of dollars of increased benefits, Fed bond-buying, expansion of the Fed balance sheet, federal fiscal deficits, and additions to the U.S. national debt. All of these things increased sharply as a percentage of the total economy. We'll see the consequences in the future.

Alan Greenspan made the Fed highly activist starting in the 1990s (giving rise to the concept of the "Greenspan put" and eventually the "Fed put"), a posture that has persisted through three financial crises already in this young century. Again, the Fed's rescue actions have been essential and appropriate, but in my view they should not be permanent. I would prefer to see a Fed that isn't continually fine-tuning, but rather one taking a "hands-off" approach most of the time and acting to stimulate or restrict the economy only at extremes.

I imagine my readers believe in the free market and, especially, its power as the best allocator of resources. In a free market, Adam Smith's "invisible hand" moves resources such as labor and capital where they can be most productive. But we don't have a free market in money today, and we haven't had one since at least 2008's Global Financial Crisis; the Fed cut the federal funds rate to zero in January 2009 and has kept it low ever since. There have been attempts to raise interest rates, but the markets greeted them with a series of "tantrums," discouraging continued efforts.

I want to make clear that I don't think I know better than the people who run the Fed. However, in general, I would like to see the economy stimulated less often, and certainly not continually. **We**

might like to have faster growth in the years ahead than the economy would provide on its own, but I don't think the long-term rate of growth can be lifted perpetually through monetary and fiscal policy, and certainly not without the risk of negative consequences.

To have a healthier allocation of capital, I'd like to see a free market in money, and to me that means interest rates that are "naturally occurring." Rates held artificially low distort the capital markets, penalizing savers, subsidizing borrowers, lifting asset prices and encouraging increased risk taking and the use of more leverage. Again, I'd prefer to see a Fed that's reluctant to intervene other than when intervention is essential.

* * *

In my first memo of the pandemic, I wrote the following about the coronavirus:

> No one knows much about it, since this is its first appearance. As Harvard epidemiologist Marc Lipsitch said on a podcast on the subject, there are (a) facts, (b) informed extrapolations from analogies to other viruses and (c) opinion or speculation. The scientists are trying to make informed inferences. Thus far, I don't think there's enough data regarding the coronavirus to enable them to turn those inferences into facts. (*Nobody Knows II*, March 3, 2020)

Substitute "economists" for "scientists" and "inflation" for "coronavirus," and I think this paragraph can serve well today. In thinking about the causes of inflation, there are few facts and only one prior inflationary episode in the U.S. in our lifetimes from which to extrapolate. **Thus, I consider anything anyone says today about inflation in the coming years to be Lipsitch's "opinion or speculation" . . . or, as I'd say, "guesswork."**

I've written in the past about the way I tend to come across great material just as memos are approaching the finish line. Thus, I want to include a quote that connects with Lipsitch's view. It's from Bill Miller, a legendary investor with an outstanding record:

> No one has privileged access to the future and market forecasts tend to be about as accurate as calling a coin toss. There are, of course, analogies that can be drawn about how the current environment maps onto previous historical data, but success in that depends crucially on how the future will, in fact, resemble the past, and whether the cited analogies turn out to be the governing ones. The record seems to show that sometimes they will and sometimes they won't and we are back at the coin toss. (*Bill Miller 2Q 2021 Market Letter,* July 9, 2021*)*

The following quote does a terrific job of summarizing the challenge entailed in decision-making in cases like this:

> **No amount of sophistication is going to allay the fact that all your knowledge is about the past and all your decisions are about the future.** (Ian H. Wilson, former GE executive)

That doesn't mean people won't express forceful opinions regarding inflation in the period ahead. As I wrote 17 years ago:

> "Confident" is the key word for describing members of [the "I know"] school. For the "I don't know" school, on the other hand, the word – especially when dealing with the macro-future – is "guarded." **Its adherents generally believe you can't know the future; you don't have to know the future; and the proper goal is to do the best possible job of investing in the absence of that knowledge.** (*Us and Them*, May 7, 2004)

So what does that mean for investor behavior today? If we can't know whether today's inflation will prove transitory or be with us for a while, is there nothing for investors to do? The answer lies in the title of a 2002 memo of mine: *You Can't Predict. You Can Prepare.* No one can confidently predict whether we're entering an inflationary era, but the consequences of doing so would be significant. Thus, I'll briefly rehash the opinion regarding market exposure that I expressed in my review of 2020.

In January's memo *Something of Value*, I described the way my genetic makeup, early experiences, and success in blowing the whistle on some unsustainable financial innovations and market excesses had turned me into something of a knee-jerk skeptic. My son Andrew called this to my attention while our families lived together last year, and what he said struck a responsive chord.

The old me likely would have latched onto today's high valuations and instances of risky behavior to warn of a bubble and the subsequent correction. But looking through a new lens, I've concluded that while those things are there, it makes little sense to significantly reduce market exposure:

- on the basis of inflation predictions that may or may not come true,
- in the face of some very positive counterarguments, and
- **when the most important rule in investing is that we should commit for the long run, remaining fully invested unless the evidence to the contrary is absolutely compelling.**

Finally, I want to briefly touch on the level of today's markets. Over the four or five years leading up to 2020, I was often asked whether we were in a high yield bond bubble. "No," I answered, "we're in a bond bubble." High yield bonds were priced fairly relative to other bonds, but all bonds were priced high because interest rates were low.

Today, we hear people say everything's in a bubble. Again, I consider the prices of most assets to be fair relative to each other. But given the powerful role of interest rates in determining those prices, and the fact that interest rates are the lowest we've ever seen, isn't it reasonable that many asset prices are the highest we've ever seen? For example, with the p/e ratio of the S&P 500 in the low 20s, the "earnings yield" (the inverse of the p/e ratio) is between 4% and 5%. To me, that seems fair relative to the yield of roughly 1.25% on the 10-year Treasury note. If the p/e ratio were at the post-World War II average of 16, that would imply an earnings yield of 6.7%, which would appear too high relative to the 10-year. That tells me **asset prices are reasonable relative to interest rates**.

Of course, it's one thing to say asset prices are fair relative to interest rates, but something very different to say rates will stay low, meaning prices will stay high (or rise). And that leads us back to inflation. It isn't hard to imagine rates increasing from here, either because the Fed lifts them to keep the economy from overheating or because rising inflation requires higher rates in order for real returns to be positive (or both). **While the possibility of rising rates (and thus lower asset prices) troubles us all, I don't think it can be said that today's asset prices are irrational relative to rates.**

Whereas folks from the media try to get me to say "buy" or "sell" and "in" or "out," I formulate my view nowadays in terms of the appropriate mix of aggressiveness versus defensiveness. Given the above crosscurrents, Oaktree is maintaining a balance between the two that's generally in line with our normal stance (as opposed to the elevated defense we maintained going into 2020).

Having said that, it's reasonable to make some adjustments at the margin in response to the risk of inflation. Investors who feel strongly about the risk, or who worry more about interim markdowns (and less about gains they might forgo if inflation fails to materialize), might wish to emphasize:

- floating-rate debt;
- investments in businesses with largely fixed costs or the ability to pass on cost increases, or that can otherwise incorporate inflation in prices (like certain landlords); and/or
- situations where profits have the potential to grow faster than prices rise.

These are all ways one might prepare today for an inflationary environment. **I consider it reasonable for investors to give a nod to the possibility of higher inflation, but not to significantly invert asset allocations in response to macro expectations that may or may not prove accurate.**

July 29, 2021

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Winds of Change

The last 20 months have been a most unusual period, thanks primarily to the pandemic, yet many things feel like they haven't changed over that time span. Each day seems like all the others. Nancy and I mostly stay home and deal with email and Zoom calls – whether relating to work matters or grandchildren. Weekdays don't feel that different from weekends (this was especially true pre-vaccine, when we rarely ate out or visited others). We've had only one one-week vacation in two years. The best way to sum it up is through a comparison to Groundhog Day: every day feels a lot like the day before.

What has changed in our environment in the last 12 months? We've seen an election and change of president, as well as increased sensitivity on issues of race, inequality and climate change – but so far with few tangible results. Fortunately, vaccines were developed, approved and distributed. Thus, Covid-19 subsided, but there was a reemergence spurred by the Delta variant, and there might be more.

In the business world, there's little that's new:

- The economic resurgence that began in the third quarter of 2020 – with the greatest quarterly GDP gain in U.S. history – remains underway.
- The securities markets, which began to rally in March 2020, have continued to rise.
- Worry about rising inflation has turned out to be well founded thus far, but there is still no consensus as to its primary cause (Federal Reserve policy or supply chain/labor market bottlenecks?) or whether it will prove transitory or long-lasting.

All three of the conditions listed above were present months ago, and they're little changed today. Thus, in the investment environment, it's still Groundhog Day. Yet there are changes taking place, and they'll be the subject of this memo. **My focus isn't the "little macro" changes, like what will happen to GDP, inflation and interest rates next year, but rather the "big macro" changes that will have an impact on our lives for many years. Many aren't actionable today, but that doesn't mean we shouldn't bear them in mind.**

<u>The Changing Environment for Investing</u>

As I've written before, the world I remember of 50, 60 and 70 years ago was a pretty static place. Things didn't seem to change very much or very fast. The homes, cars, reading matter, business technology and general environment of 1970 weren't very different from those of 1950. We were entertained by broadcast TV and radio, drove gasoline-powered cars dependent on carburetors, did most calculations on paper, composed documents on typewriters (with copies made using carbon paper), communicated via letters and phone calls, and got information primarily from books housed in libraries. The four-function calculator, personal computer, cellular phone, email and Internet didn't yet exist, and some of them wouldn't for a good while longer. I describe this environment as a mostly unchanging backdrop – I think of it as scenery in the theater – in front of which events and cycles played out.

One of the biggest changes that did take place in the 1960s was the emergence of "growth investing" via fast-growing companies, many of which were quite new. The "Nifty Fifty" I talk about so much ruled the stock market in the late 1960s: this group included office equipment manufacturers IBM and Xerox, photography titans Kodak and Polaroid, drug companies like Merck and Eli Lilly, tech companies including Hewlett Packard and Texas Instruments, and advanced marketing/consumer goods companies such as Coca-Cola and Avon.

These companies' stocks carried very high price/earnings ratios, reaching up to 80 and 90. Obviously, investors should only pay multiples like these (if ever) if they're sure the companies will be preeminent for decades to come. And investors were sure. In fact, it was widely believed that nothing bad could happen to these companies and they could never be disrupted. **This was one of post-war America's first major brushes with newness and – in a good example of illogicality – investors embraced these companies, with their revolutionary newness, but somehow assumed that a newer and better new thing could never come along to displace them.**

Of course, those investors were riding for a fall. If you bought the stocks of "the greatest companies in America" when I started working in 1969, and held them steadfastly for five years, you lost almost all your money. The first reason is that the multiples in the late 1960s were far too high, and they were gutted in the subsequent market correction. But, perhaps more importantly, many of these "forever" companies turned out to be vulnerable to change.

The companies of the Nifty Fifty represented the first flowering of change in the new world, and many of them went on to be its early victims. At least half of these supposedly impregnable companies have either gone out of business or been acquired by others. Kodak and Polaroid lost their *raison d'etre* when digital cameras appeared. Xerox ceded much of the dry copying business to low-priced competition from abroad. IBM proved vulnerable when decentralized computing and PCs took over from massive mainframes. Seen any door-to-door salespeople lately? No, and we don't hear much about "Avon ladies." And what about one of the darlings of the day: Simplicity Pattern? Who do you know today who makes their own clothes?

The years since then have seen a massive shift in our environment. **Today, unlike in the 1950s and '60s, everything seems to change every day.** It's particularly hard to think of a company or industry that won't either be a disrupter or be disrupted (or both) in the years ahead. Anyone who believes all the firms on today's list of leading growth companies will still be there in five or ten years has a good chance of being proved wrong.

For investors, this means there's a new world order. Words like "stable," "defensive" and "moat" will be less relevant in the future. Much of investing will require more technological expertise than it did in the past. And investments made on the assumptions that tomorrow will look like yesterday must be subject to vastly increased scrutiny.

<ins>The Changing Nature of Business</ins>

Increasingly, U.S. business is virtual, digital and information-oriented, no longer devoted to agriculture or to manufacturing physical products. Even those companies that do produce physical goods or services increasingly employ information products and other aspects of technology. These elements will have a profound impact on which legacy businesses will survive, which moats will hold up, and which newcomers will supplant the incumbents, as well as what our world will look like ten or twenty years from now.

In my January memo, Something of Value, I described some of the changes technology is making in the business world. They included:

- the exceptional profitability of information-based businesses;
- these companies' low cost of incremental production, relative ease of scaling, and ability to see margins rise as the business expands, rather than suffer diminishing returns;
- their modest need for additional capital and bigger plants as they grow, and
- their reliance on a relatively small number of educated coders rather than masses of manual or unskilled workers.

Not only do these factors have the potential to create massive winners and bring down others, but they have profound implications for the overall economy. I think about one of them more than the rest. (Since Oaktree and I generally don't invest in technology, I'm not required to have opinions on much of the foregoing.) **That one is the fact that as technology and information play a bigger role in business and our lives, labor becomes less necessary.**

One hundred years ago, the U.S. was an agricultural powerhouse, and agriculture was highly labor-intensive. Thus large numbers of unskilled workers were employed on U.S. farms, largely in the South and Midwest. With the invention of machine-powered equipment, the need for labor in agriculture declined. Large numbers of workers displaced by tractors made their way to the upper Midwest to work in plants producing newly invented automobiles and household appliances. Thus workers who were displaced from one field found employment in another – there were industries on the way up as well as on the way down.

Fast forward to the 21st century. The industries to which those workers and their descendants shifted are in turn losing jobs, this time due to the importation of foreign goods made with cheap labor and, especially, automation. With manufacturing on the decline in the U.S., it's technological industries – in fields such as information, artificial intelligence, communications and entertainment – that are rising to take the place of metal-bending. And as mentioned above, tech firms can increase their production and sales without a proportional increase in the number of workers employed.

The optimists say, "some new need for labor always pops up" (as it did in manufacturing between 1920 and, say, 1970). But (a) you can't see much sign of that in the tech-based industries that are on the rise – they're just not labor-intensive – and (b) the workers that technological industries require are generally better educated than those cut adrift from the manufacturing sector. This latter element is especially worrisome given the declining quality of public education available in the U.S. (There is, however, room for growth in jobs in the service sector.)

I worry about where the workers no longer needed in manufacturing will find employment. For those who look to government for solutions, the most likely answer is support payments designed to guarantee everyone a living wage. But can we afford to support growing numbers of unemployed workers and their families? And how will we replace the non-monetary benefits from work: things like having a place to go each day and satisfaction with a job well done. Is sitting on the porch really a viable substitute for a job? I believe the opioid epidemic, for example, is highly correlated with job losses. Government largesse isn't an adequate substitute for jobs.

Inflation/Deflation

I've written extensively on the subject of inflation of late, especially in *Thinking About Macro* four months ago. Since our knowledge of the future is so limited, there's little for me to add on the subject. But what about the possibility of deflation? People have been warning about both inflation and deflation for the last several years. The only thing I've been confident about is that we're unlikely to have both at the same time.

I recently came across a video of Cathie Wood speaking on the subject of deflation. For those who don't know, Cathie is the investor who gained great fame in 2020 for having been heavily concentrated in the FAANGs, Tesla and other tech stocks, which vastly outperformed the rest of the stock market (in 2020, the average return on five of her seven ETFs was 141%). In the video, Cathie says:

> We've been saying for some time that the risk to the economy is more on the side of deflation than inflation. So, as Covid created all the destruction that it did and with supply chains really being thrown off, we've been through a period here of inflation which I think investors are baking into the cake. . . .
>
> . . . I was in college [during the 1970s], when inflation was raging, so I know what that is, and I truly believe we are not going back there, and that anyone planning for it is probably going to be making some mistakes. . .
>
> On the innovation side, technologically enabled innovation – we are in a period today like we have never been. Never! I mean you have to go back to the telephone, electricity and the automobile to see three major technologically enabled sources of innovation evolving at the same time. **Today we have five platforms: DNA sequencing, robotics, energy storage, artificial intelligence and blockchain technology, all of which are deflationary, and not just by a little bit, either.** (Emphasis added)

She goes on to cite Jeff Gundlach, Ray Dalio and me, and maybe Stan Druckenmiller, as being concerned about a deflationary bust. (To be honest, my only comment possibly relevant to that assertion was to say that technological gains *can* be a deflationary factor – not that the *overall result* would be deflation.) She continues:

> We think [the deflationary bust] is going to be balanced by a deflationary boom, so that's where we differ. But where we agree is that there are companies who thought the world would never change and have been catering to short-term shareholders who wanted that extra penny or two in earnings and so got it by having the companies lever up and take more debt and shrink the number of shares, and they've also been focused on dividends. They are probably saddled with products and services that will become obsolete because of the record-breaking amount of innovation taking place today. And in order to service their debt, they are going to have to cut prices and move those goods and services that are on their way out anyway. . . So what it will mean is that the traditional GDP numbers we're going to be seeing are going to be very low and growth will seem very scarce. . . .
>
> There will be a lot of job displacement, there will be, no question about it. In fact, when we started our company in 2014, Oxford University had just put out a piece that said 47% of all jobs in the United States would be lost to automation and artificial intelligence by 2035. And they left it there. Hair on fire, headlines screaming, a lot of fear about automation. We got the question in every meeting. And what they had neglected to do – which we did – was finish the story.

> With automation and artificial intelligence, productivity is going to go up dramatically. We think more than it ever has, certainly in modern times. And with productivity increases comes more wealth creation, and more GDP creation, and according to our estimates, in the year 2035, because of automation and artificial intelligence, we believe that GDP here in the United States will not be $28 trillion, which, if you drew linear growth, that's where it would be, but instead will be $40 trillion . . .

Before I move on, I want to spend a minute on exactly what Cathie Wood said: technology will prove deflationary, and its positive impact on productivity will contribute to a jump in GDP. But GDP is the product of the number of hours worked times labor productivity per hour. **Thus, if technology produces a big increase in output per hour worked, GDP can grow even if the number of hours worked declines. In other words, technology has the potential to boost GDP while adding to unemployment.**

We don't hear much these days about the possibility of deflation, and it certainly seems unlikely to arise. We also don't hear much about the deflationary impact of technology, but we shouldn't dismiss the idea.

<u>The Outlook for Work</u>

While on the subject of work, I want to mention a few changes that could add up to a sea change ("a profound or notable transformation"). Whereas religious observance had long made it traditional for workers to have a day off on their Sabbath, in the early 1900s Henry Ford began to give his workers both Saturday and Sunday off. (He wasn't motivated solely by generosity. He wanted to sell cars and figured people would buy more of them if they had two-day weekends during which to enjoy them.) That was a major innovation, but today having Saturday and Sunday off is so universal that few people wonder how weekends came to be.

Now, we might be in for another major change in work patterns. It wasn't long ago that most people wanted full-time employment and pursued careers affording opportunities for advancement. Now, however, a lot of that is out the window.

- Computers made it easier to track people who wanted to work irregularly – a day or two here and a few hours there – and "gig work" such as driving for Uber became popular.
- The pandemic made working from home commonplace and the requirement to work in an office five days a week less of a default solution.
- Millions of people have left jobs over the last year as part of the "Great Resignation": 4.4 million in September alone.
- Many people seem to attach less importance to lifetime careers and advancement.
- The unemployment rate is quite low, even as millions of jobs are unfilled. Per the October Institute for Supply Management report on services: "Labor is still an issue, as it's hard to find and get people who want to work, especially in services, trucking and warehouse fulfillment."

These changes have important implications: work arrangements are less standardized, workers seem less enthralled by a steady paycheck, and many employees expect to be allowed to work from home. In 2020 we saw a drop in the labor force participation rate (the percentage of working-age Americans employed or looking for work) from 63.4% to 60.2%, and it has since rebounded to only 61.1%. What's behind these developments? Since economic phenomena aren't governed by physical laws, precise causes are hard to ascertain. In this case, I can think of a large number of possible explanations:

- The slower economic growth seen since roughly 2000 reduced the rate of job creation and advancement, and this may have made concepts like career and long-term employment less appealing to some young people.
- Along similar lines, some members of younger generations may have become disaffected because of the increase in income inequality and decrease in prospects for economic mobility.
- Many people can afford not to work – at least for a while – perhaps because they've made more money not working than they did working (thanks to stimulus checks and/or expanded unemployment benefits). Money from these sources piled up in savings accounts, and it may not have been entirely spent yet.
- Homeowners may be reveling in the paper appreciation on their homes and borrowing against it to allow them to forgo a paycheck.
- The extensive work-from-home experience during the pandemic got people out of the habit of "going to work" and made doing so less automatic. The experience may also have highlighted how unpleasant commuting is, reducing some people's willingness to reengage in it.
- The ebullient markets may have encouraged some to quit their jobs in order to take up day trading or cryptocurrency investments.
- Some people moved during the pandemic, whether to escape Covid-19 or simply because WFH permitted it. Now some don't want to return. In particular, WFH reduced the need for some to live near jobs in urban areas with a high cost of living. Others may have enjoyed spending time with family and decided to switch to jobs permitting them to do more of it.
- Having seen how good it is for kids to have parents around, some families may have opted to become one-worker households, giving up on the fast track and potentially higher standards of living facilitated by two incomes.
- People nearing retirement may be choosing to start it now rather than seek a job for the interim.
- Labor shortages (e.g., involving truck drivers) have increased workers' bargaining power and given them the ability to move to better-paying jobs.
- Employers' desperate straits have caused some to lower job requirements, enabling workers to move up from low-paying jobs.
- People wanting to return to work may be having trouble finding childcare, since low-paid childcare workers may be able to find jobs that pay more.
- Finally, some people may still be prevented from returning to work by fear of Covid-19.

To sum up, many workers experienced a "timeout" during the pandemic – not working, working part-time, working from home, and/or certainly not traveling on business. For many, this may have occasioned a reset, giving them an opportunity to conclude, "You know, my career isn't everything; family and quality of life count for more. I'm going to reorient my life and put less emphasis on work."

At the present time, roughly 7.4 million Americans are unemployed and there are 11.2 million job openings. Sounds like it should be easy to put everyone to work and fill those positions. But the people who aren't employed may lack the required qualifications, may be unwilling to accept a job that doesn't allow them to work from home, may not want to adhere to fixed schedules, or may be unable to pass drug tests, etc. Just as with the supply chain, it may take a while to get all the moving parts to the right place.

I've listed a large number of changes here, mostly stemming from the pandemic. Some may disappear in the coming months as things get "back to normal." But others may turn out to be permanent and in five or ten years cause us to say, "Remember how different things were before 2020?"

The Outlook for Democracy

There's a great but little-used word to describe the state of U.S. politics and governance: parlous. Google defines it as "full of danger or uncertainty; precarious." The country is highly divided in terms of politics, and discourse seems to move further toward the extremes with the passage of time.

Part of the blame goes to the media (including social media). The explanation is simple but unfortunate: a few entrepreneurs figured out that there's money in division. At the birth of television, as I understand it, the people who ran the national networks established the news division as a public service that ran losses. In TV's early decades (through the 1970s), the main networks did balanced, objective reporting – led by august figures such as Walter Cronkite, Chet Huntley and David Brinkley – and these networks pretty much still do. But over the last 20 years, some media outlets have increased their profits by catering to one side or the other, often in an inflammatory manner. More recently, we've heard about social media driving traffic by appealing to highly partisan audiences and disclaiming responsibility for content. The truth is, discord sells (how often does your daily newspaper lead with a positive headline?).

The result is very harmful. It's bad enough that some cable news stations and social media sites deliver only one side of the argument on many issues. But increasingly, they provide "alternative facts" that allow Americans to inhabit different realities. This leads to further polarization and to hostility toward those with whom one disagrees. It doesn't take long for disagreement to turn into dislike. Without a commonly agreed-on set of facts, it's easy to doubt the good faith of those with contrary views, undermining the very basis of our democracy.

Today, Americans are more likely to live near people who share their political views, express similar opinions, and favor candidates who fully back their party's agenda. Because which party will win the general election is a foregone conclusion in the vast majority of congressional elections, the real competition is in the primary election for the dominant party's nomination, which often goes to a candidate espousing an extreme version of the party's dogma. The winner – typically chosen by the small number of partisans who vote in primaries – almost always goes on to win the general election, creating a Congress heavily weighted with extremists from both parties.

Some politicians not only contribute to the division we're seeing but also benefit from it in the form of increased campaign contributions and media attention. The non-competitive nature of many congressional elections encourages behavior that in the past was considered unacceptable: acting in an uncivil manner, attacking colleagues, expressing opinions that were previously taboo, and advocating extreme measures. Many elected officials appear to follow a variation on "all's fair in love and war": all tactics are okay if they motivate my supporters, get me reelected and help my party gain or retain power.

One might conclude that all the above is innocuous – something like a TV drama. It contributes to gridlock, and there are people who believe gridlock is the best we can hope for from Washington, because so many of the government's active decisions are flawed. But these trends have worrisome implications.

Competition in the political arena has moved from intellectual/ideological to personal. As recent voting shows, our country is splitting in two, including in terms of demographics. This may be nothing new, but the forces of division are getting stronger. I believe "clustering" – the tendency to live near people like oneself – is growing, and along with it the level of dislike, disrespect and resentment toward "the other." The political impact of clustering can be exacerbated by gerrymandering, which gives the dominant party seats and power disproportionate to its share of voters. (In many states, the drawing of voting districts is in the hands of the state legislature, where the dominant party can use its ability to gerrymander, or manipulate voting district boundaries, to perpetuate and perhaps increase its hold on power.)

These things complicate life in our so-called democracy (per Oxford University's online dictionary *Lexico*, "a system of government by the whole population or all the eligible members of a state" or "control of an organization or group by the majority of its members"). When I was a kid, we settled schoolyard disputes by insisting "majority rules." When we look at the U.S. system, however, we see numerous ways in which our form of government violates principles like representative democracy, majority rule, and "one person, one vote." For example:

- Whereas seats in the House of Representatives are allocated to the states in proportion to their populations, each state has two seats in the Senate. California, with 39 million people, has the same clout in the Senate as Wyoming with its 578,000. **Thus the 26 smallest states, with only 57.6 million people (17.7% of the total U.S. population), theoretically could elect 52 senators and control the Senate.**

- U.S. presidents aren't chosen on the basis of who gets the most popular votes, but by who gets a majority in the Electoral College. The 538 electors in the College are apportioned to the states on the basis of population, which is democratic, but in 48 states the Electoral College votes go to candidates on a winner-take-all basis, which is not. Thus, a candidate could win by one vote in each of the 39 least-populated states and Washington, D.C. (receiving 47.0 million out of their combined 93.9 million votes if all the registered voters went to the polls); get all 270 of their electors; and win the presidency even if another candidate got 100% of the 120.0 million votes in the 11 most populous states. **In other words, in this extreme example, a U.S. president can be elected with just 47.0 million votes (22.0% of the total) versus 166.9 million for his or her opponent.** (Note that if the percentage turnout in the least-populated states were lower than in the others, the former could elect a president with an even smaller percentage of the total popular vote.)

  In the last 100 years, presidents have often been elected with significant majorities of the popular vote. The highest were for Lyndon B. Johnson – 61.1% in 1964; Franklin D. Roosevelt – 60.8% in 1936; Richard Nixon – 60.7% in 1972; and Ronald Reagan – 58.8% in 1984. But the winner of the last eight presidential elections only received between 43.0% and 52.9% of the vote, and presidents were elected twice with fewer popular votes than the loser.

These anti-democratic aspects of our system of government have been present for centuries. But the U.S. version of democracy generally worked because people and parties generally: (a) recognized that democracy is fragile and can only survive if most citizens feel the system is fair and legitimate; (b) believed that majority rule should be tempered by respect for minority rights; and (c) valued progress for the country at least as highly as political power. Thus, political leaders played by unwritten rules and hewed to traditional norms of behavior intended to foster a stable democracy. For most of our history, only fringe voices suggested our elections could be conducted dishonestly or questioned the outcome. Now, this thinking is going mainstream. I worry about this trend.

Clustering and gerrymandering increase the already-substantial influence of one party or the other in many states, and state legislatures' control over elections opens the door for possible shenanigans. Secretary of state and membership on boards of elections have historically been non-partisan positions (and pretty boring). Increasingly, appointment or election can put partisan officials in charge of the election process. Both new laws and new political norms seem to have opened the door for legislators and election officials to behave in ways that were previously unthinkable. Ultimately, there's nothing to keep state legislatures from appointing slates of electors who will vote for the dominant party's nominee regardless of the popular vote in their states. **Serious potential threats to our democracy exist, and no one can say what the future holds in this regard.**

I've written in the past about my involvement with the group No Labels and its backing of bipartisan solutions to our nation's problems. Our organization brings together both Democrats and Republicans – as well as both senators and representatives, who heretofore rarely spoke to each other – and I think No Labels deserves credit for some of the important laws that have been enacted this year on a bipartisan basis, most notably the infrastructure bill President Biden just signed into law.

In the six years I've been an active member of No Labels, my eyes have been opened to something I wasn't aware of. **In short, I think very few people appreciate how undemocratic Congress is.** As I see it, each house of Congress has been firmly under the control of the leader elected by the majority party. On matters of importance, if the Speaker of the House or Majority Leader of the Senate wanted something to happen, it generally happened. And if a leader didn't want something to happen, it generally didn't happen. This one-person rule (a) seems highly suspect in what purports to be a democracy and (b) makes you wonder why we send senators and representatives to Washington (that is, if the leader can set the agenda and tell the members how to vote, why not just let the leader in each house run the whole thing?). And if the legislators on the two opposing sides follow the instructions from their leaders, which presumably are on a strict party-line basis, by definition there can't be bipartisan legislation.

And I think bipartisan government and bipartisan legislation are absolutely essential for the health of our democracy. The alternative is that the majority party does what it wants, including passing laws with no concurrence from the other party. (Some measures can be passed in the Senate with as few as 51 votes under a process called "reconciliation," overcoming resistance via filibuster – see below). When either party passes legislation on a straight party-line vote:

- The legislation doesn't have to be moderate enough to attract votes from the other side.
- It's easy for the minority party to vilify the new law and the people behind it.
- There's every likelihood that the minority party will reverse it when they gain a majority – to the detriment of Americans who need a stable, predictable environment in which to live and do business.

And that brings me to the infrastructure bill signed into law on November 15 and the unusual course it took in contrast to what I just described. First, it passed in the Senate on August 10 with support from all 50 Democrats but also 19 Republicans (in this case, Minority Leader Mitch McConnell freed his members to vote their conscience). But the bill encountered resistance in the House, where so-called progressive Democrats refused to vote for it unless the House first passed a "Build Back Better" bill, with trillions of dollars for safety-net programs unrelated to physical infrastructure. That became the basis for the intricate kabuki theater that played out over the last three months.

The infrastructure bill approved by the Senate could have been passed in the House in August. But partisan squabbles imperiled it, since most Republicans didn't want to give President Biden's Democratic administration a victory and some progressive Democrats wanted to use their leverage to hold the bill hostage until the moderates voted for theirs. Rather than call a vote immediately on the infrastructure bill, House Speaker Nancy Pelosi (perhaps wanting to placate the progressive members of her Democratic caucus) tied the two bills together, even though the BBB bill had yet to be fleshed out, debated, or "scored" in terms of its effect on the federal budget. Later, under pressure, she agreed in writing to work to pass the infrastructure bill and hold a vote on it by September 27, but she failed to do so (with no consequences).

What ensued was a real game of chicken. The Speaker demanded that the moderates commit to vote for the BBB bill first, but a small number of moderates (enough to prevent Democrats from achieving the necessary 218-vote majority threshold for passing a bill) refused to do so and demanded a vote on the infrastructure bill first. The moderates' action felt like an uprising against the House leadership of a sort that has rarely been seen in recent years. But then on November 2, Democrats lost the governorship in Virginia and nearly lost it in highly Democratic New Jersey. The Biden administration's resultant need for a "win" caused the bill to be brought to the House floor just three days later, where it was approved by all the Democrats except for six progressives, as well as by 13 moderate Republicans. The result was passage by a vote of 228 to 206, an outcome achieved despite resistance from the Speaker up to the last moment.

It's easy for legislators who don't want to support a bill to find provisions they say are objectionable, and they did so in this case. But I believe that on balance the provisions of the infrastructure law will help the vast majority of congressional districts; thus I suspect some of the 206 representatives who voted against it may have done so at the expense of potential benefits for their constituents. **What's the word for that? My answer is "politics," which is, in part, defined by Oxford as "the debate or conflict among individuals or parties having or hoping to achieve power."**

Widespread dissatisfaction with both major parties could conceivably lead to the creation of a third party to appeal to Americans in the middle. But with more than two main parties dividing up the votes, there would be significant obstacles to any one of them achieving a clear win. And that's where the complications set in. Under the U.S. form of government, it's doubtful that minority party candidates can be elected and coalitions formed. More importantly, if candidates from more than two major parties vie for the presidency, it would be difficult for one to achieve a majority in the Electoral College. In that case, the election would be decided by the House of Representatives, with each state having one vote regardless of population. Thus, we'd be back to the problem regarding the Senate described on page eight: 26 states with a tiny share of the total population could end up appointing the president. **While my examples describe extreme hypothetical outcomes, these are not imaginary concerns.**

Finally under the heading of politics, I'll touch on the filibuster. For those who are unfamiliar with it, the filibuster is a procedural tool that allows the minority in the Senate to bottle up legislation and require 60 votes for passage, rather than a simple majority of 51. Because the party in power usually has fewer than 60 seats, as is the case today (seats are 50/50), the filibuster often gives the minority party a veto over legislation. And whereas the parties have always done battle over policy, today things are so politicized that the minority party often has no goal other than to thwart the majority party's agenda.

Because of Republicans' opposition to many Democratic priorities, there is growing pressure within the Democratic party to use their slim majority in the Senate to eliminate the filibuster (the vice president presides over the Senate, meaning today's Democratic vice president has the ability to break the 50/50 tie).

Will the Democrats eliminate the filibuster? Should they? And if they do, how will they feel when the Republicans someday are in the majority and are no longer constrained by the filibuster? Without rehashing the entire debate, I'll merely point to the dilemma involved. Proponents of the filibuster argue that it requires the party in power to shape legislation capable of attracting minority-party support and that this prevents the passage of extreme laws. But opponents point out that these days, with the minority often dedicated to nothing but obstruction, the existence of the filibuster merely ensures inaction. (Note, however, that the results with the infrastructure bill show that bipartisan action isn't entirely impossible, and a lot of minor legislation is passed that way with little attention.) **The ability to pass laws with a one-seat majority facilitates the tyranny of the majority. But the ability of 41 Senators to halt a bill's progress permits the tyranny of the minority.** Which is worse? Obviously, this choice of tyrannies is one of the challenges faced in our democracy. There are no easy answers. (And if Democratic traditionalists refrain from eliminating the filibuster, what's to keep Republicans from getting rid of it the next time they have a majority?)

Generational Inequity

In 2037 and 2026, respectively, Social Security and Medicare, benefit programs that aid older Americans, will likely become unable to continue paying today's benefits. And yet we don't hear any discussion of the benefit cuts, delayed eligibility, tax increases, or means testing that would have to be part of any solution. In fact, in the last 18 months Washington has approved more than $9 trillion of spending on Covid-19 relief and infrastructure, but we haven't heard a word from either party about fixing these essential programs. That's presumably because the party that trims these programs would likely be penalized at the polls.

The 71.2 million members of the Baby Boom generation (people born between roughly 1946 and 1964) are triple the 23.0 members of the Silent Generation that preceded them and 10% more than the 65.0 million Generation Xers that followed. **The magnitude of the Boomers' votes and financial resources have given them enormous political influence over the last 40 years. The result has been extensive deficit spending on things the Boomers want and a failure to modify benefit programs that need fixing, all at the expense of future generations.**

This is an example of the generational unfairness that has been perpetrated in recent decades. In short – in a way that many Americans probably don't recognize – administrations of both parties have been (and still are) spending vast amounts, taxing less than they should relative to their spending (thus incurring deficits), and running up the national debt, largely favoring the Baby Boomers who are now America's very numerous retirees. Here's the history of the U.S. national debt:

Year	Billions $	% of GDP
1955	274	64%
1975	533	31
1995	4,794	64
2015	18,151	100
2019	22,719	107
2021	28,400	125

In short, the Baby Boomers have been and still are consuming more than their fair share of the pie. This will leave future generations saddled with substantial debt stemming from expenditures they didn't benefit from proportionally.

Social Security, while not part of the federal budget, provides a good example. It wasn't set up as a funded program, but as an insurance scheme operating on a pay-as-you-go-basis, under which current receipts from workers are used to make payments to retirees. Social Security tax receipts aren't added to an endowment, other than on a temporary basis, and benefits are paid out of current taxes on workers, not endowment income. But nowadays we have fewer people working for each retiree they support, and retirees are living longer than they used to. These trends endanger the system. Changes have to be made, but they're not. Thus, 16 years from now (if not before), Social Security taxes will have to be raised, benefits (or at least their rate of increase) will have to be trimmed, and/or Social Security will have to become a federal obligation rather than a self-sustaining insurance scheme, adding to the deficit. This is only one of the many ways in which future generations will be penalized for the overspending my generation engaged in.

Foundations and universities have rules governing endowment spending, the main purpose of which is to balance the interests of the current generation against those of generations to come. This is a prime fiduciary responsibility of endowed institutions. Likewise, most of today's parents won't spend their way to unreasonable credit card balances and saddle their heirs with debt. While the significance of national debt is debatable, as is the question of how much debt is "too much," it's hard to argue that recent administrations in Washington have been appropriately balancing the interests of all generations. (And, by the way, today's generations have been happy to consume an unsustainable share of the earth's resources to fuel their lifestyles, which is certain to leave future generations with a degraded environment. This is another profound aspect of generational inequity.)

In August 2008, on the way to ending my memo *What Worries Me*, I included a passage from the 2004 book *Running on Empty* by Pete Peterson (for those who weren't in the business world in the 20th century, Pete held important positions in government and co-founded Blackstone with Steve Schwarzman):

> . . . while our problems are not yet intractable, both political parties are increasingly incorrigible. They are not facing our problems, they are running from them. They are locked into a politics of denial, distraction, and self-indulgence that can only be overcome if readers like you take back this country from the ideologues and spin doctors of both the left and the right. . . .
>
> With faith-driven catechisms that are largely impervious to analysis or evidence, and that seem removed from any kind of serious political morality, both political parties have formed an unholy alliance – an undeclared war on the future. An undeclared war, that is, on our children. **From neither party do we hear anything about sacrificing today for a better tomorrow. In some ways, our most formidable challenge may be our leaders' baffling indifference to our fiscal metastasis**. (Emphasis added)

The good news is that we've muddled through and enjoyed a good measure of prosperity despite the existence of these issues. The bad news is that little or nothing has been done about them.

The Role of the Fed

I won't spend a great deal of time on this subject since everyone knows the story. But it has to be part of a memo that purports to discuss important changes that are underway.

Historically, the job of central banks has been to control the level of inflation and make sure the economy grows fast enough to create "full employment." In recent years, however, the Fed seems to have taken on the additional task of keeping the securities markets on an upward trajectory. This has been achieved through the radical lowering of interest rates and the injection of massive amounts of liquidity into the economy.

The Fed funds rate – the bellwether of short-term interest rates in the U.S. – was reduced to zero for the first time during the Global Financial Crisis of 2008-09. And it worked – what followed was the longest economic recovery in U.S. history. But rates weren't raised when the recovery was at its strongest, and when they finally were raised in 2017-18, the markets threw a tantrum and the Fed backed down, cutting rates instead.

Now the Fed funds rate is zero again, the markets are far higher than they were in the last decade, and we're seeing serious inflation. The Fed has announced that it's going to "taper" its stimulative program of bond buying, and it is widely expected that it will begin to raise interest rates next year. Will the impact on the economy be highly negative? Will the markets revolt again, and will a market correction convince the Fed to go back to a low-interest-rate regime? Will the Fed keep asset prices rising in perpetuity as the optimists think is now its job?

For me, the expectation that the Fed can keep the economy and markets rising without interruption is too good to be true. And I continue to believe the economy will perform best in the long run if it's a free market economy, which does the best job of moving resources to their optimal use. As Richard Masson, my Oaktree co-founder, wrote in 2008, "Creative destruction and a functioning market economy assure change toward the best solution over time." We could use a free market in money.

Larry Goodman, president of the Center for Fiscal Stability, recently wrote as follows:

> Since [2010], Fed purchases of Treasury debt have funded as much as 60% to 80% of the entire government borrowing requirement. In other words, Fed actions have crowded out private-sector price discovery for more than 10 years, pushing yields to lows and stock prices to record highs. . . .
>
> In fiscal 2021, the Fed purchased $1 trillion in Treasury debt, and the Treasury drained $1.6 trillion from its savings account at the Fed. These actions covered nearly the entire budget deficit, equal to . . . nearly all the pandemic-related government borrowing. Based on monthly estimates, there was actually a funding surplus this past summer. It is no wonder the 10-year Treasury yield reached a low of 1.17% in August despite high inflation rates. (*The Wall Street Journal*, November 18, 2021)

So guess what: The U.S. is still able to issue debt at low interest rates, a ringing endorsement of its creditworthiness from buyers. **And who's the main buyer supplying that endorsement? The U.S.**

By the way, a few progressive Democrats have announced their opposition to the reappointment of Jerome Powell as Fed chair, because they think he's not active enough in addressing climate change. So now we have a Fed that's supposed to control inflation, foster growth and employment, support markets, and fight climate change. How many roles can one institution have and still maintain a coherent effort?

Developments in China

In the 43 years since the Maoist period ended in 1978, China has been the fastest growing major economy in the world. And it continued to grow in 2020, when no other large economies did. Will the superior growth continue? Will China become the world's biggest economy? The answers to these questions will be very important.

My key observation is that China has had to navigate an unusually large number of transitions:

- from farm to city,
- from agriculture to manufacturing and services,
- from mass poor to a significant middle class,
- from economic reliance on exports to domestic consumption,
- from growth based on capital investment to more organic growth, and
- from emerging nation to world power.

As these processes move forward in the years ahead, China will have to balance central control and free enterprise (for which they understand the need). At the same time, the country has to respect the rule of law but still enact the policies it wants. And I believe it will have to eliminate the reliance on bailouts from Beijing and put up with bankruptcies, the resultant losses and, dare I say, economic cyclicality.

The question I find most interesting is how China simultaneously manages central control of the economy and private enterprise, while both pursuing economic efficiency and upholding socialist ideology. This has puzzled me throughout the 15 years I've been going there. The Chinese people have great respect for the Communist Party, and it and its leaders have a lot of levers to pull, free of the impediments that come with that cumbersome thing called democracy. But the private sector is full of entrepreneurship and seems to run very well.

Within the last year, President Xi has cracked down on financial celebrities, economic inequality and industries considered unhealthy for society, such as for-profit education. Nevertheless, I believe everyone in a position of power has taken note of the economic miracle that followed the elimination of Maoism and the substitution of the profit motive for quotas and equal sharing. It's my guess that China's "dual system" will continue to function well and private enterprise will continue to be respected, as long as it operates in a way consistent with "Xi Jinping Thought."

The transitions listed above are already underway. Tackling all of them simultaneously has to be seen as a daunting task. But China has extensive resources as well as strong centralized control. No one can prove they will pull it off or that they won't – the best we can have on questions like this is a hunch. Mine is that the Chinese economy will continue to grow faster than the rest of the world and may well become the largest economy. **I believe with time we'll see all the above transitions take place. The process just won't be smooth and free of glitches.**

For the last few years, I've been a member of the Shanghai International Financial Advisory Council. This has permitted me to see the extent to which China is dedicated to attracting foreign capital and making Shanghai a world financial center, and I believe China understands that doing so will require adherence to the rule of law and good conduct as a member of the global community. Hopefully that means the worst fears regarding its behavior won't be realized.

<u>The T-Word</u>

As best I can tell, 2020 was the first year the word "trillion" came into common use. Everett Dirksen (R-IL) is described (perhaps apocryphally) as having said, "A billion here, a billion there, and pretty soon you're talking real money." Now billions have been reduced to pocket change, and it takes trillions to amount to "real money."

I doubt most people could actually explain what a trillion is (that is, they likely have no idea that it's a thousand billion, or a million million). And the scale of a trillion is almost incomprehensible. I was struck 30-40 years ago to learn that whereas a million dollars is $10 a second for 28 hours, a billion dollars is $10 a second for 38 months. **Now let's think about a trillion: $10 a second for more than 3,000 years. As I said, almost incomprehensible.**

Elected officials throw around the term trillions (and spend trillions) without a way to really appreciate the implications. What's next? I saw a great cartoon the other day that consisted of a drawing of the Capitol dome and the caption "What comes after trillions?" If we live long enough, I'm sure we'll find out.

*   *   *

With all these significant changes underway, it's easy to think the world is unusually complicated these days and to long for the way things were in the old days. On the other hand, at times like this I think back to something former Dallas Cowboys quarterback Don Meredith once said while providing commentary on *Monday Night Football*: "They don't make 'em the way they used to. But then again, they never did." Current times usually seem difficult, and we fondly remember the halcyon earlier days. But the past certainly wasn't as comfortable as we remember it, and there were more challenges than we often recall.

Senior economics consultant Neil Irwin summed up our situation very well in *The New York Times* on April 16, 2020 (I borrowed this quote for inclusion in my May 2020 memo *Uncertainty*.):

> The world economy is an infinitely complicated web of interconnections. We each have a series of direct economic interrelationships we can see: the stores we buy from, the employer that pays our salary, the bank that gives us a home loan. But once you get two or three levels out, it's really impossible to know with any confidence how those connections work. . . .
>
> In the years ahead we will learn what happens when that web is torn apart [by the pandemic and resultant lock-down], when millions of those links are destroyed all at once. And it opens the possibility of a global economy completely different from the one that has prevailed in recent decades.

All I have to add to that is my usual observation regarding the future: We'll see.

November 23, 2021

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Memo to: Oaktree Clients

From: Howard Marks

Re: Selling Out

As I'm now in my fourth decade of memo writing, I'm sometimes tempted to conclude I should quit, because I've covered all the relevant topics. Then a new idea for a memo pops up, delivering a pleasant surprise. My January 2021 memo *Something of Value*, which chronicled the time I spent in 2020 living and discussing investing with my son Andrew, recounted a semi-real conversation in which we briefly discussed whether and when to sell appreciated assets. It occurred to me that even though selling is an inescapable part of the investment process, I've never devoted an entire memo to it.

The Basic Idea

Everyone is familiar with the old saw that's supposed to capture investing's basic proposition: "buy low, sell high." It's a hackneyed caricature of the way most people view investing. But few things that are important can be distilled into just four words; thus, "buy low, sell high" is nothing but a starting point for discussion of a very complex process.

Will Rogers, an American film star and humorist of the 1920s and '30s, provided what he may have thought was a more comprehensive roadmap for success in the pursuit of wealth:

> Don't gamble; take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don't go up, don't buy it.

The illogicality of his advice makes clear how simplistic this adage – like many others – really is. However, regardless of the details, people may unquestioningly accept that they should sell appreciated investments. But how helpful is that basic concept?

Origins

Much of what I'll write here got its start in a 2015 memo called *Liquidity*. The hot topic in the investment world at that moment was the concern about a perceived decline in the liquidity provided by the market (when I say "the market," I'm talking specifically about the U.S. stock market, but the statement has broad applicability). This was commonly attributed to a combination of (a) the licking investment banks had taken in the Global Financial Crisis of 2008-09 and (b) the Volcker Rule, which prohibited risky activities such as proprietary trading on the part of systemically important financial institutions. The latter constrained banks' ability to "position" securities, or buy them, when clients wanted to sell.

Maybe liquidity in 2015 was less than it had previously been, and maybe it wasn't. However, looking beyond the events of the day, I closed that memo by stating my conviction that (a) most investors trade too much, to their own detriment, and (b) the best solution for illiquidity is to build portfolios for the long term that don't rely on liquidity for success. Long-term investors have an advantage over those with short timeframes (and I think the latter describes the majority of market participants these days). Patient investors are able to ignore short-term performance, hold for the long run, and avoid excessive trading costs, while everyone else worries about what's going to happen in the next month or quarter and therefore trades excessively. In addition, long-term investors can take advantage if illiquid assets become available for purchase at bargain prices.

Like so many things in investing, however, just holding is easier said than done. Too many people equate activity with adding value. Here's how I summed up this idea in *Liquidity*, inspired by something Andrew had said:

> When you find an investment with the potential to compound over a long period, one of the hardest things is to be patient and maintain your position as long as doing so is warranted based on the prospective return and risk. Investors can easily be moved to sell by news, emotion, the fact that they've made a lot of money to date, or the excitement of a new, seemingly more promising idea. **When you look at the chart for something that's gone up and to the right for 20 years, think about all the times a holder would have had to convince himself not to sell.**

Everyone wishes they'd bought Amazon at $5 on the first day of 1998, since it's now up 660x at $3,304.

- But who would have continued to hold when the stock hit $85 in 1999 – up 17x in less than two years?
- Who among those who held on would have been able to avoid panicking in 2001, as the price fell 93%, to $6?
- And who wouldn't have sold by late 2015 when it hit $600 – up 100x from the 2001 low? Yet anyone who sold at $600 captured only the first 18% of the overall rise from that low.

This reminds me of the time I once visited Malibu with a friend and mentioned that the Rindge family is said to have bought the entire area – all 13,330 acres – in 1892 for $300,000, or $22.50 per acre. (It's clearly worth many billions today.) My friend said, "I'd like to have bought all of Malibu for $300,000." My response was simple: "you would have sold it when it got to $600,000."

The more I've thought about it since writing *Liquidity*, the more convinced I've become that there are two main reasons why people sell investments: because they're up and because they're down. You may say that sounds nutty, but what's really nutty is many investors' behavior.

Selling Because It's Up

"Profit-taking" is the intelligent-sounding term in our business for selling things that have appreciated. To understand why people engage in it, you need insight into human behavior, because a lot of investors' selling is motivated by psychology.

In short, a good deal of selling takes place because people like the fact that their assets show gains, and they're afraid the profits will go away. Most people invest a lot of time and effort trying to avoid unpleasant feelings like regret and embarrassment. What could cause an investor more self-recrimination than watching a big gain evaporate? And what about the professional investor who reports a big winner to clients one quarter and then has to explain why the holding is at or below cost the next? It's only human to want to realize profits to avoid these outcomes.

If you sell an appreciated asset, that puts the gain "in the books," and it can never be reversed. Thus, some people consider selling winners extremely desirable – they love realized gains. In fact, at a meeting of a non-profit's investment committee, a member suggested that they should be leery of increasing endowment spending in response to gains because those gains were unrealized. I was quick to point out that it's usually a mistake to view realized gains as less transient than unrealized ones (assuming there's no reason to doubt the veracity of the unrealized carrying values). Yes, the former have been made concrete. However, sales proceeds are generally reinvested, meaning the profits – and the principal – are put back at risk. One might argue that appreciated securities are more vulnerable to declines than new investments in assets currently deemed to be attractively priced, but that's far from a certainty.

I'm not saying investors shouldn't sell appreciated assets and realize profits. **But it certainly doesn't make sense to sell things just because they're up.**

<u>Selling Because It's Down</u>

As wrong as it is to sell appreciated assets solely to crystalize gains, it's even worse to sell them just because they're down. Nevertheless, I'm sure many people do it.

While the rule is "buy low, sell high," clearly many people become more motivated to sell assets the more they decline. **In fact, just as continued buying of appreciated assets can eventually turn a bull market into a bubble, widespread selling of things that are down has the potential to turn market declines into crashes. Bubbles and crashes do occur, proving that investors contribute to excesses in both directions.**

In a movie that plays in my head, the typical investor buys something at $100. If it goes to $120, he says, "I think I'm onto something – I should add," and if it reaches $150, he says, "Now I'm highly confident – I'm going to double up." On the other hand, if it falls to $90, he says, "I'm going to think about increasing my position to reduce my average cost," but at $75, he concludes he should reconfirm his thesis before averaging down further. At $50, he says, "I'd better wait for the dust to settle before buying more." And at $20 he says, "It feels like it's going to zero; get me out!"

Just like those who are afraid of surrendering gains, many investors worry about letting losses compound. They might fear their clients will say (or they'll say to themselves), "What kind of a lame-brain continues to hold a security after it's gone from $100 to $50? *Everyone knows* a decline like that can foreshadow further declines. And look – it happened."

Do investors really make behavioral errors such as those I've described? There's plenty of anecdotal evidence. For example, studies have shown that the average mutual fund investor performs worse than the average mutual fund. How can that be? If she merely held her positions, or if her errors were unsystematic, the average fund investor would, by definition, fare the same as the average fund. For the studies' findings to occur, investors have to on balance reduce the amount of capital they have in funds that subsequently do better and increase their allocation to funds that go on to do worse. Let me put that another way: on average, mutual fund investors tend to sell the funds with the worst recent performance (missing out on their potential recoveries) in order to chase the funds that have done the best (and thus likely participate in their return to earth).

We know that "retail investors" tend to be trend-followers, as described above, and their long-term performance often suffers as a result. What about the pros? Here the evidence is even clearer: the powerful shift in recent decades toward indexing and other forms of passive investing has taken place for the simple reason that active investment decisions are so often wrong. Of course, many forms of error contribute to this reality. Whatever the reason, however, we have to conclude that, on average, active professional investors held more of the things that did less well and less of the things that outperformed, and/or that they bought too much at elevated prices and sold too much at depressed prices. Passive investing hasn't grown to cover the majority of U.S. equity mutual fund capital because passive results have been so good; I think it's because active management has been so bad.

Back when I worked at First National City Bank 50 years ago, prospective clients used to ask, "What kind of return do you think you can make in an equity portfolio?" The standard answer was 12%. Why? "Well," we said (so simplistically), "the stock market returns about 10% a year. A little effort should enable us to improve on that by at least 20%." Of course, as time has shown, there's no truth in that. "A little effort" didn't add anything. In fact, in most cases, active investing detracted: most equity funds failed to keep up with the indices, especially after fees.

What about the ultimate proof? The essential ingredient in Oaktree's investments in distressed debt – bargain purchases – has emanated from the great opportunities sellers gave us. Negativity reaches a crescendo during economic and market crises, causing many investors to become depressed or fearful and sell in panic. Results like those we target in distressed debt can only be achieved when holders sell to us at irrationally low prices.

Superior investing consists largely of taking advantage of mistakes made by others. Clearly, selling things because they're down is a mistake that can give the buyers great opportunities.

<u>When Should Investors Sell?</u>

If you shouldn't sell things because they're up, and you shouldn't sell because they're down, is it ever right to sell? As I previously mentioned, I described the discussions that took place while Andrew and his family lived with Nancy and me in 2020 in *Something of Value*. That experience truly was of great value – an unexpected silver lining to the pandemic. That memo evoked the strongest reaction from readers of any of my memos to date. This response was probably attributable to (a) the content, which mostly related to value investing; (b) the personal insights provided, and especially my confession regarding my need to grow with the times; or (c) the recreated conversation that I included as an appendix. The last of these went like this, in part:

> Howard: Hey, I see XYZ is up xx% this year and selling at a p/e ratio of xx. Are you tempted to take some profits?
>
> Andrew: Dad, I've told you I'm not a seller. Why would I sell?
>
> H: Well, you might sell some here because (a) you're up so much; (b) you want to put some of the gain "in the books" to make sure you don't give it all back; and (c) at that valuation, it might be overvalued and precarious. And, of course, (d) no one ever went broke taking a profit.
>
> A: Yeah, but on the other hand, (a) I'm a long-term investor, and I don't think of shares as pieces of paper to trade, but as part ownership in a business; (b) the company still has enormous potential; and (c) I can live with a short-term downward fluctuation, the threat

of which is part of what creates opportunities in stocks to begin with. Ultimately, it's only the long term that matters. (There's a lot of "a-b-c" in our house. I wonder where Andrew got that.)

H: But if it's potentially overvalued in the short term, shouldn't you trim your holding and pocket some of the gain? Then if it goes down, (a) you've limited your regret and (b) you can buy in lower.

A: If I owned a stake in a private company with enormous potential, strong momentum and great management, I would never sell part of it just because someone offered me a full price. Great compounders are extremely hard to find, so it's usually a mistake to let them go. Also, I think it's much more straightforward to predict the long-term outcome for a company than short-term price movements, and it doesn't make sense to trade off a decision in an area of high conviction for one about which you're limited to low conviction. . . .

H: Isn't there any point where you'd begin to sell?

A: In theory there is, but it largely depends on (a) whether the fundamentals are playing out as I hope and (b) how this opportunity compares to the others that are available, taking into account my high level of comfort with this one.

Aphorisms like "no one ever went broke taking a profit" may be relevant to people who invest part-time for themselves, but they should have no place in professional investing. **There certainly are good reasons for selling, but they have nothing to do with the fear of making mistakes, experiencing regret and looking bad.** Rather, these reasons should be based on the outlook for the investment – not the psyche of the investor – and they have to be identified through hardheaded financial analysis, rigor and discipline.

Stanford University professor Sidney Cottle was the editor of the later versions of Benjamin Graham and David L. Dodd's *Security Analysis*, "the bible of value investing," including the edition I read at Wharton 56 years ago. For that reason, I knew the book as "Graham, Dodd and Cottle." Sid was a consultant to the investment department at First National City Bank in the 1970s, and **I've never forgotten his description of investing: "the discipline of relative selection."** In other words, most of the portfolio decisions investors make are relative choices.

It's patently clear that relative considerations should play an enormous part in any decision to sell existing holdings.

- If your investment thesis seems less valid than it did previously and/or the probability that it will prove accurate has declined, selling some or all of the holding is probably appropriate.
- Likewise, if another investment comes along that appears to have more promise – to offer a superior risk-adjusted prospective return – it's reasonable to reduce or eliminate existing holdings to make room for it.

Selling an asset is a decision that must not be considered in isolation. Cottle's concept of "relative selection" highlights the fact that every sale results in proceeds. What will you do with them? Do you have something in mind that you think might produce a superior return? What might you miss by switching to the new investment? And what will you give up if you continue to hold the asset in your portfolio rather than making the change? Or perhaps you don't plan to reinvest the proceeds. In that case, what's the likelihood that holding the proceeds in cash will make you better off than you would have been if you had held onto the thing you sold? **Questions like these relate to the concept of "opportunity cost," one of the most important ideas in financial decision-making.**

Switching gears, what about the idea of selling because you think a temporary dip lies ahead that will affect one of your holdings or the whole market? There are real problems with this approach:

- Why sell something you think has a positive long-term future to prepare for a dip you expect to be temporary?
- Doing so introduces one more way to be wrong (of which there are so many), since the decline might not occur.
- Charlie Munger, vice chairman of Berkshire Hathaway, points out that selling for market-timing purposes actually gives an investor two ways to be wrong: the decline may or may not occur, and if it does, you'll have to figure out when the time is right to go back in.
- Or maybe it's three ways, because once you sell, you also have to decide what to do with the proceeds while you wait until the dip occurs and the time comes to get back in.
- People who avoid declines by selling too often may revel in their brilliance and fail to reinstate their positions at the resulting lows. Thus, even sellers who were right can fail to accomplish anything of lasting value.
- Lastly, what if you're wrong and there is no dip? In that case, you'll miss out on the ensuing gains and either never get back in or do so at higher prices.

So it's generally not a good idea to sell for purposes of market timing. **There are very few occasions to do so profitably and very few people who possess the skill needed to take advantage of these opportunities.**

Before I close on this subject, it's important to note that decisions to sell aren't always within an investment manager's control. Clients can withdraw capital from accounts and funds, necessitating sales, and the limited lifespan of closed-end funds can require managers to liquidate holdings even though they're not ripe for selling. The choice of *what to sell* under these conditions can still be based on a manager's expectations regarding future returns, but deciding *not to sell* isn't among the manager's choices.

How Much Is Too Much to Hold?

Certainly there are times when it's right to sell one asset in favor of another based on the idea of relative selection. But we mustn't do this in a mechanical manner. If we did, at the logical extreme, we would put all of our capital into the one investment we consider the best.

Virtually all investors – even the best – diversify their portfolios. We may have a sense for which holding is the absolute best, but **I've never heard of an investor with a one-asset portfolio. They may overweight favorites to take advantage of what they think they know, but they still diversify to protect against what they don't know.** That means they sub-optimize, potentially trading off some of their chance at a maximal return to increase the likelihood of a merely excellent one.

Here's a related question from my reconstructed conversation with Andrew:

> H: You run a concentrated portfolio. XYZ was a big position when you invested, and it's even bigger today, given the appreciation. Intelligent investors concentrate portfolios and hold on to take advantage of what they know, but they diversify holdings and sell as things rise to limit the potential damage from what they don't know. Hasn't the growth in this position put our portfolio out of whack in that regard?
>
> A: Perhaps that's true, depending on your goals. But trimming would mean selling something I feel immense comfort with based on my bottom-up assessment and moving into something I feel less good about or know less well (or cash). To me, it's far better to own a small number of things about which I feel strongly. I'll only have a few good insights over my lifetime, so I have to maximize the few I have.

All professional investors want good investment performance for their clients, but they also want financial success for themselves. And amateurs have to invest within the limits of their risk tolerance. For these reasons, most investors – and certainly most investment managers' clients – aren't immune to apprehension regarding portfolio concentration and thus susceptibility to untoward developments. These considerations introduce valid reasons for limiting the size of individual asset purchases and trimming positions as they appreciate.

Investors sometimes delegate the decision on how to weight assets in portfolios to a process called portfolio optimization. Inputs regarding asset classes' return potential, risk and correlation are fed into a computer model, and out comes the portfolio with the optimal expected risk-adjusted return. If an asset appreciates relative to the others, the model can be rerun, and it will tell you what to buy and sell. The main problem with these models lies in the fact that all the data we have regarding those three parameters relates to the past, but to arrive at the ideal portfolio, the model needs data that accurately describes the future. Further, the models need a numerical input for risk, and I absolutely insist that no single number can fully describe an asset's risk. Thus, optimization models can't successfully dictate portfolio actions.

The bottom line:

- we should base our investment decisions on our estimates of each asset's potential,
- we shouldn't sell just because the price has risen and the position has swelled,
- there can be legitimate reasons to limit the size of the positions we hold,
- but there's no way to scientifically calculate what those limits should be.

In other words, the decision to trim positions or to sell out entirely comes down to judgment . . . like everything else that matters in investing.

The Final Word on Selling

Most investors try to add value by over- and underweighting specific assets and/or through well-timed buying and selling. While few have demonstrated the ability to consistently do these things correctly (see my comments on active management on page 4), everyone's free to have a go at it. There is, however, a big "but."

What's clear to me is that simply being invested is by far "the most important thing." (Someone should write a book with that title!) Most actively managed portfolios won't outperform the market as a result of manipulation of portfolio weightings or buying and selling for purposes of market timing. **You can try to add to returns by engaging in such machinations, but these actions are unlikely to work at best and can get in the way at worst.**

Most economies and corporations benefit from positive underlying secular trends, and thus most securities markets rise in most years and certainly over long periods. One of the longest-running U.S. equity indices, the S&P 500, has produced an estimated compound average return over the last 90 years of 10.5% per year. That's startling performance. It means $1 invested in the S&P 500 90 years ago would have grown to roughly $8,000 today.

Many people have remarked on the wonders of compounding. For example, Albert Einstein reportedly called compound interest "the eighth wonder of the world." If $1 could be invested today at the historic compound return of 10.5% per year, it would grow to $147 in 50 years. One might argue that economic growth will be slower in the years ahead than it was in the past, or that bargain stocks were easier to find in previous periods than they are today. Nevertheless, even if it compounds at just 7%, $1 invested today will grow to over $29 in 50 years. **Thus, someone entering adulthood today is practically guaranteed to be well fixed by the time they retire if they merely start investing promptly and avoid tampering with the process by trading.**

I like the way Bill Miller, one of the great investors of our time, put it in his *3Q 2021 Market Letter*:

> In the post-war period the US stock market has gone up in around 70% of the years . . . Odds much less favorable than that have made casino owners very rich, yet most investors try to guess the 30% of the time stocks decline, or even worse spend time trying to surf, to no avail, the quarterly up and down waves in the market. Most of the returns in stocks are concentrated in sharp bursts beginning in periods of great pessimism or fear, as we saw most recently in the 2020 pandemic decline. **We believe time, not timing, is the key to building wealth in the stock market.** (October 18, 2021. Emphasis added)

What are the "sharp bursts" Miller talks about? On April 11, 2019, *The Motley Fool* cited data from JP Morgan Asset Management's *2019 Retirement Guide* showing that in the 20-year period between 1999 and 2018, the annual return on the S&P 500 was 5.6%, but your return would only have been 2.0% if you had sat out the 10 best days (or roughly 0.4% of the trading days), and you wouldn't have made any money at all if you had missed the 20 best days. In the past, returns have often been similarly concentrated in a small number of days. Nevertheless, overactive investors continue to jump in and out of the market, incurring transactions costs and capital gains taxes and running the risk of missing those "sharp bursts."

As mentioned earlier, investors often engage in selling because they believe a decline is imminent and they have the ability to avoid it. The truth, however, is that buying or holding – even at elevated prices – and experiencing a decline is in itself far from fatal. Usually, every market high is followed by a higher one and, after all, only the long-term return matters. **Reducing market exposure through ill-conceived selling – and thus failing to participate fully in the markets' positive long-term trend – is a cardinal sin in investing. That's even more true of selling without reason things that have fallen, turning negative fluctuations into permanent losses and missing out on the miracle of long-term compounding.**

*   *   *

When I meet people for the first time and they find out I'm in the investment business, they often ask (especially in Europe) "what do you trade?" That question makes me bristle. To me, "trading" means jumping in and out of individual assets and whole markets on the basis of guesswork as to what prices will do in the next hour, day, month or quarter. We don't engage in such activity at Oaktree, and few people have demonstrated the ability to do it well.

Rather than traders, we consider ourselves investors. **In my view, investing means committing capital to assets based on well-reasoned estimates of their potential and benefitting from the results over the long term.** Oaktree does employ people called traders, but their job consists of implementing long-term investment decisions made by portfolio managers based on assets' fundamentals. No one at Oaktree believes they can make money or advance their career by selling now and buying back after an intervening decline, as opposed to holding for years and letting value lift prices if fundamental expectations prove out.

When Oaktree was formed in 1995, the five founders – who at that point had worked together for nine years on average – established an investment philosophy based on what we'd successfully done in that time. One of the six tenets expressed our view on trying to time markets when buying and selling:

> Because we do not believe in the predictive ability required to correctly time markets, we keep portfolios fully invested whenever attractively priced assets can be bought. Concern about the market climate may cause us to tilt toward more defensive investments, increase selectivity or act more deliberately, but we never move to raise cash. Clients hire us to invest in specific market niches, and we must never fail to do our job. Holding investments that decline in price is unpleasant, but missing out on returns because we failed to buy what we were hired to buy is inexcusable.

We've never changed any of the six tenets of our investment philosophy – including this one – and we have no plans to do so.

January 13, 2022

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Pendulum in International Affairs

As regular readers of my memos and books know, I'm strongly interested in – you might say obsessed with – the concept of the pendulum. The following is only a partial list of my writings on the subject:

- My second memo, written in April 1991, was creatively titled *First Quarter Performance*. It talked about the oscillation in securities markets between euphoria and depression; between celebrating positive developments and obsessing over negatives; and thus between overpriced and underpriced assets.
- *On Regulation*, written in March 2011, discussed the outlook for rulemaking stemming from the Global Financial Crisis. I said future developments were likely to be driven by the long-term pendulum-like swing in attitudes on that subject. Over time, those attitudes tend to fluctuate between "the markets best serve the country when they're unfettered by rules" to "we need the government to protect us from participants' misbehavior."
- In *The Role of Confidence*, from August 2013, I discussed the way shifts in fundamentals are translated into market volatility by often-excessive swings in investor confidence.
- And in my 2018 book, *Mastering the Market Cycle*, I interrupted my discussion of the various cycles – in the economy, corporate profits, credit availability, etc. – to use the metaphor of a pendulum, not a cycle, to describe the swings of investor psychology.

Because psychology swings so often toward one extreme or the other – and spends relatively little time at the "happy medium" – I believe the pendulum is the best metaphor for understanding trends in anything affected by psychology . . . not just investing.

People frequently ask what caused me to start writing memos in 1990. My very first memo, *The Route to Performance*, resulted from two events I witnessed in short order, the juxtaposition of which led to what I thought was an important observation. Over the years, many memos have been prompted by connections I sensed between ostensibly unconnected events.

At a recent meeting of the Brookfield Asset Management board, a discussion of Ukraine triggered an association with another aspect of international affairs – offshoring – which I first discussed in the memo *Economic Reality* (May 2016). Thus the inspiration for this memo.

Background

The first item on the agenda for Brookfield's board meeting was, naturally, the tragic situation in Ukraine. We talked about the many facets of the problem, ranging from human to economic to military to geopolitical. In my view, energy is one of the aspects worth pondering. The desire to punish Russia for its unconscionable behavior is complicated enormously by Europe's heavy dependence on Russia to meet its energy needs; Russia supplies roughly one-third of Europe's oil, 45% of its imported gas, and nearly half its coal.

Since it can be hard to arrange for alternative sources of energy on short notice, sanctioning Russia by prohibiting energy exports would cause a significant dislocation in Europe's energy supply. Curtailing this supply would be difficult at any time, but particularly so at this time of year, when people need to heat their homes. That means Russia's biggest export – and largest source of hard currency ($20 billion a month is the figure I see) – is the hardest one to sanction, as doing so would cause serious hardship for our allies. Thus, the sanctions on Russia include an exception for sales of energy commodities. This greatly complicates the process of bringing economic and social pressure to bear on Vladimir Putin. In effect, we're determined to influence Russia through sanctions . . . just not the potentially most effective one, because it would require substantial sacrifice in Europe. More on this later.

The other subject I focused on, offshoring, is quite different from Europe's energy dependence. One of the major trends impacting the U.S. economy over the last year or so – and a factor receiving much of the blame for today's inflation – relates to our global supply chains, the weaknesses of which have recently been on display. Thus, many companies are seeking to shorten their supply lines and make them more dependable, primarily by bringing production back on shore.

Over recent decades, as we all know, many industries moved a significant percentage of their production offshore – primarily to Asia – bringing down costs by utilizing cheaper labor. This process boosted economic growth in the emerging nations where the work was done, increased savings and competitiveness for manufacturers and importers, and provided low-priced goods to consumers. But the supply-chain disruption that resulted from the Covid-19 pandemic, combined with the shutdown of much of the world's productive capacity, has shown the downside of that trend, as supply has been unable to keep pace with elevated demand in our highly stimulated economy.

At first glance, these two items – Europe's energy dependence and supply-chain disruption – may seem to have little in common other than the fact that they both involve international considerations. But I think juxtaposing them is informative . . . and worthy of a memo.

Russian Energy

In 2019, Russia's top four exports were crude petroleum, refined petroleum, petroleum gas, and coal briquettes. These totaled $223 billion, or 55% of Russia's total exports of $407 billion, according to the Observatory of Economic Complexity.

As shown in the following table, Russia is exceptionally well positioned to wield influence over Europe through exports of energy commodities.

	Europe			**Russia**		
	Produces	**Consumes**	**Net**	**Produces**	**Consumes**	**Net**
Oil (bbl/day)	3.6 mm	15.0 mm	(11.4 mm)	11.0 mm	3.4 mm	7.6 mm
Gas (cu met/year)	230 bn	560 bn	(330 bn)	700 bn	400 bn	300 bn
Coal (tons/year)	475 mm	950 mm	(475 mm)	800 mm	300 mm	500 mm

Source: "The West's Green Delusions Empowered Putin," Michael Shellenberger, *Common Sense with Bari Weiss*, March 1, 2022. Some data is approximate or rounded. (*Common Sense* is probably as tendentious as other media outlets, but I have no reason to believe the data is inaccurate.)

The implications are clear. Europe uses far more energy than it produces and makes up the difference through imports. Russia, on the other hand, uses far less than it produces, leaving the remainder to generate economic and strategic gains.

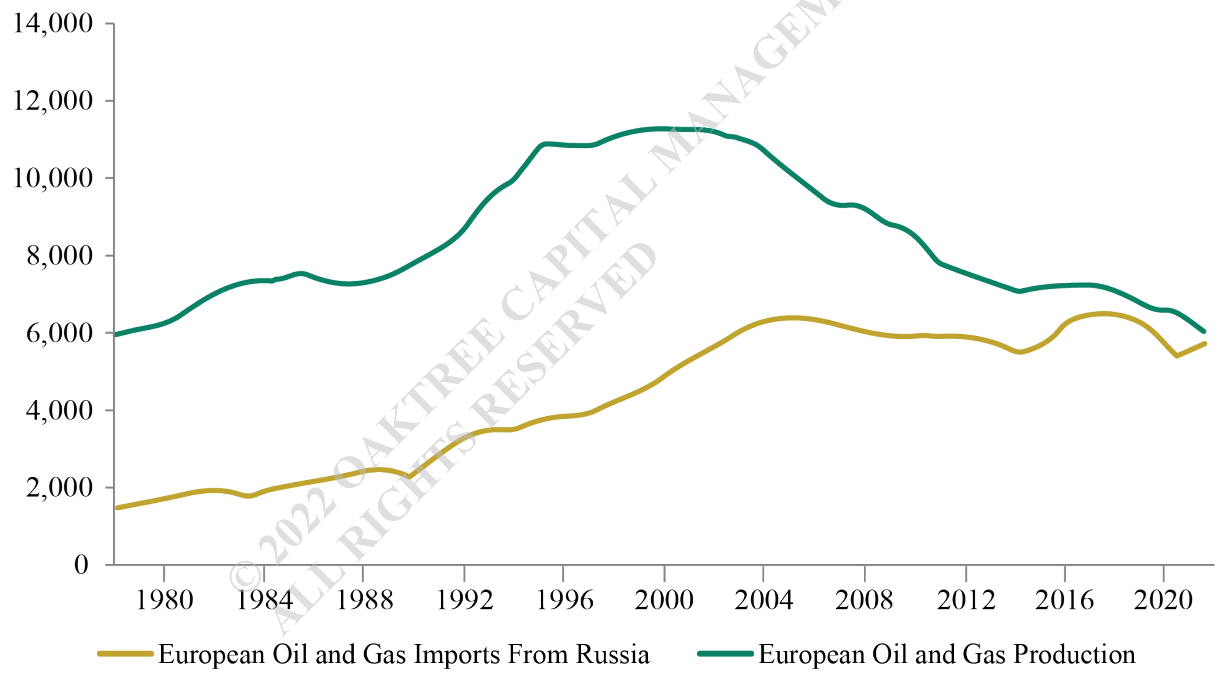
How did things get this way? According to Shellenberger (see source above):

> While Putin expanded Russia's oil production, expanded natural gas production, and then doubled nuclear energy production to allow more exports of its precious gas, Europe, led by Germany, shut down its nuclear power plants, closed gas fields, and refused to develop more through advanced methods like fracking.
>
> The numbers tell the story best. In 2016, 30 percent of the natural gas consumed by the European Union came from Russia. In 2018, that figure jumped to 40 percent. By 2020, it was nearly 44 percent, and by early 2021, it was nearly 47 percent.

The following chart makes the situation clear. In 1980, imports from Russia represented less than one-third of Europe's oil and gas production. European production peaked about 20 years ago and has almost halved since then, ending up near where it was in 1980. In the same roughly 40-year period, imports from Russia have tripled, meaning they're now roughly equal to Europe's production.

European Reliance on Russian Energy

Thousand Barrels Per Day of Oil Equivalent



Source: BP, Gazprom, Eurostat, Perovic et al., Russia Federal Customs Service. *Journal of Policy Analysis and Management* calculations, 2021.

Shellenberger asserts – and it seems credible – that Europe allowed its dependence on imports of energy commodities, especially from Russia, to increase so dramatically because it wanted to be more ecologically responsible at home. In addition to limiting their production of oil and gas, some nations (especially Germany) reduced their use of nuclear power generation – which could arguably offer the best energy option by providing large-scale power production without emitting greenhouse gases – in a concession to those who consider nuclear power unsafe or environmentally unfriendly. As Shellenberger puts it:

> At the turn of the millennium, Germany's electricity was around 30 percent nuclear-powered. But Germany has been sacking its reliable, inexpensive nuclear plants. . . . By 2020, Germany had reduced its nuclear share from 30 percent to 11 percent. Then, on the last day of 2021, Germany shut down half of its remaining six nuclear reactors. The other three are slated for shutdown at the end of this year.

During a briefing earlier this month, a U.S. senator told the nonpartisan political organization No Labels, "The energy issue regarding 'Putin's war' has four components: energy, climate, security, and economics (both national and at the household level)." **Security doesn't seem to have received much consideration in the deliberations that led to Germany's energy dependency on Russia.** Just one of the four factors – climate – appears to have motivated the decision. Choosing to count on a hostile neighbor for essential goods is like building a bank vault and contracting with the mob to supply it with guards. But that's what happened.

<u>Foreign Sourcing</u>

The downside of Europe's dependence on Russian oil and gas has made its way into the consciousness of many people only recently, as a result of the invasion of Ukraine. But the shift to sourcing and manufacturing overseas is something that's been on people's minds for decades.

If you think back a few hundred years, limitations on transportation required that production take place near the point of consumption. But after the advent of the railroad, it became possible to separate the locations of production and consumption by hundreds – or even thousands – of miles. This must have been an important element in the creation of national champions that eventually supplied whole countries with goods such as food and building materials that previously had to be manufactured near the local customers. This enabled goods to be produced in places where labor was most readily available or where benefits from specialization could be maximized. It was inevitable that these forces would affect countries around the world and – with the emergence of airfreight and containerization – result in rapidly growing cross-border trade.

Shortly after World War II, cheap labor and skill in assembling products permitted Japan to rapidly become a major exporter of electronic goods and automobiles. The products were highly cost-competitive and initially of low quality, but Japan soon developed some of the world's most desired brands. In the late 1950s, Japanese auto companies exported just a few hundred cars a year to the U.S., the main selling point of which was low price. But quality rose even as prices remained attractive, and by the early 1980s, the Reagan administration, in an attempt to protect the U.S. auto industry, asked Japanese manufacturers to "voluntarily" limit exports to the U.S. to 1.68 <u>million</u> cars per year.

The lure of low manufacturing costs caused producers to shift operations from Japan to other parts of Asia over time. A large-scale shift to China began in earnest around 1995. Subsequently, the production of low-value-added goods such as T-shirts and jeans shifted to Vietnam, Bangladesh and Pakistan. As each country benefited from the growth of manufacturing, the supply of labor got tighter, and workers became able to demand higher wages. Per-capita incomes and standards of living rose, expanding the middle class and strengthening domestic consumption. Higher wages in one country caused the mantle of lowest-cost manufacturer to pass to others. Wages may have risen locally, but as a consequence, the search for low-margin, low-skill work moved on to new low-cost venues.

Asia's ability to produce goods inexpensively soon led U.S. companies to capitalize on Asia's advantages by (a) building factories abroad and (b) hiring Asian contractors to do manufacturing for them. The reasons are clear: vastly lower wages and fewer protections for workers, which permitted long days and poor labor conditions that wouldn't be tolerated in the U.S. **The result was more jobs for non-U.S. workers, economic growth for the countries where the manufacturing was done, increased competitiveness for U.S. importers, and bargain-priced goods for American consumers.**

In addition, offshoring undoubtedly contributed substantially to the low level of inflation experienced in the U.S. over the last 40 years. One popular gauge of inflation, the Personal Consumption Expenditures (PCE) deflator, rose by only 1.8% per year from 1995 (importantly, the blast-off point for Chinese exports to the U.S.) through 2020. Inflation was considered tame at that level, and, in fact, many in business and government wished it were a bit higher. But a look inside the numbers is instructive:

Personal Consumption Expenditures	Annual Inflation	Share of PCE
All	**1.8%**	
Non-Durables	1.6	25-30%
Durables	(2.0)	10-15
Services	2.6	55-60

Source: Federal Reserve Bank of St. Louis FRED database; *AmosWEB*

It's startling to note that the prices of durables fell by almost 40% over the 25 years in question. The availability of ever-cheaper goods like cars, appliances and furniture produced abroad was a major contributor to the benign U.S. inflation picture in this quarter-century. Likewise, although prices of non-durables didn't actually come down, cheap imports of items like clothing helped keep the lid on prices overall. This was an important benefit of globalization for the net-importing nations.

On the other hand, offshoring also led to the elimination of millions of U.S. jobs, the hollowing out of the manufacturing regions and middle class of our country, and most likely the weakening of private-sector labor unions.

> Ford, for example, reported in 1992 that 53 percent of its employees worked in the U.S. and Canada. By 2009, its North American workforce (by then Ford had expanded to Mexico) made up only 37 percent of total payroll. (*The Week*, January 11, 2015)

Capitalism is based on the desire to maximize income. Globalization allows production to be performed where the costs are lowest. The combination of these two powerful forces has had a profound influence on the world over the last half-century.

Semiconductors present an outstanding example of this trend. Many of the most important early developments in electronics – transistors, integrated circuits, and semiconductors – took place at U.S. companies such as Bell Labs and Fairchild Semiconductor. In 1990, the U.S. and Europe were responsible for over 80% of global semiconductor production. By 2020, their share was estimated to be only around 20% (data from Boston Consulting Group and the Semiconductor Industry Association). Taiwan (led by Taiwan Semiconductor Manufacturing Company (TSMC)) and South Korea (essentially Samsung) have taken the place of the U.S. and Europe as the largest producers of semiconductors. Today, "TSMC and Samsung are the only companies capable of producing today's most advanced 5-nanometer chips that go into iPhones." (*Visual Capitalist*) The upshot is well known:

> While pandemic-induced shutdowns have hampered supply, the demand for chips has continued surging with reopening economies. The resulting chip shortage has rattled

several industries with lead times – the gap between when a semiconductor is ordered and when it is delivered is at a record high of 22 weeks.

The chip shortage is a boon to semiconductor companies, but downstream firms are struggling. Global automakers are set to make 7.7 million fewer cars in 2021, which translates into a $210 billion hit to their revenues. Consumer electronics have taken a blow as well, with popular products like the PlayStation 5 console in short supply. (*Visual Capitalist*)

<u>The Common Thread</u>

So, what's the connection? U.S. companies' foreign sourcing, in particular with regard to semiconductors, differs from Europe's energy emergency in many ways. **But both are marked by inadequate supply of an essential good demanded by countries or companies that permitted themselves to become reliant on others. And considering how critical electronics are to U.S. national security – what today in terms of surveillance, communications, analysis and transportation isn't reliant on electronics? – this vulnerability could, at some point, come back to bite the U.S. in the same way that dependence on Russian energy resources has the European Union.**

How did the world get into this position? How did Europe become so dependent on Russian exports of energy commodities, and how did such a high percentage of semiconductors and other goods destined for the U.S. come to be manufactured abroad? Just as Europe allowed its energy dependence to increase due to its desire to be more green, U.S. businesses came to rely increasingly on materials, components, and finished goods from abroad to remain price-competitive and deliver greater profits.

Key geopolitical developments in recent decades included (a) the perception that the world was shrinking, due to improvements in transportation and communications, and (b) the relative peace of the world, stemming from:

- the dismantling of the Berlin Wall;
- the fall of the USSR;
- the low perceived threat from nuclear arms (thanks to the realization that their use would assure mutual destruction);
- the absence of conflicts that could escalate into a multi-national war; and
- the shortness of memory, which permits people to believe benign conditions will remain so.

Together, these developments gave rise to a huge swing of the pendulum toward globalization and thus countries' interdependence. Companies and countries found that massive benefits could be tapped by looking abroad for solutions, and it was easy to overlook or minimize potential pitfalls.

As a result, in recent decades, countries and companies have been able to opt for what seemed to be the cheapest and easiest solutions, and perhaps the greenest. Thus, the choices made included reliance on distant sources of supply and just-in-time ordering.

(As an aside, I acknowledge that in countries with less-well-developed economies, environmental protection, high safety and labor standards, and green behavior may sometimes be considered unaffordable luxuries. Thus offshoring may allow companies to engage in practices that wouldn't be acceptable at home – low-cost manufacturing based on burning coal is a good example. In this way, offshoring may help a company's or even a country's domestic profile while being bad for the world as a whole.)

As I've written in the past, economics is the science of choice (the same seems true of geopolitics, although there's even less science regarding that realm.) Few options in these fields offer only positives and no negatives. Most entail tradeoffs. However, the negatives often become apparent "only when the tide goes out," as they have recently. The invasion of Ukraine has shown that Europe's importation of oil and gas from Russia has left it vulnerable to a hostile, unprincipled nation (worse in this case – to such an individual) at the same time that winding down nuclear power generation has increased the region's need for imported oil and gas. The practice of offshore procurement similarly makes countries and companies dependent on their positive relations with foreign nations and the efficacy of our transportation system.

The recognition of these negative aspects of globalization has now caused the pendulum to swing back toward local sourcing. Rather than the cheapest, easiest and greenest sources, there'll probably be more of a premium put on the safest and surest. For example, both U.S. and non-U.S. companies have announced that they intend to build new foundries to produce semiconductors in the U.S. And I imagine many U.S. importers of materials, components and finished goods are looking for sources closer to home. Similarly, it's now less likely that Germany will follow through on its plan to turn off its three remaining nuclear reactors on December 31 and more likely that it will reactivate the three it retired at the end of 2021 (and perhaps, with the rest of Europe, recalibrate the balance between energy imports and domestic energy production).

If the pendulum continues to move for a while in the direction I foresee, there will be ramifications for investors. Globalization has been a boon for worldwide GDP, the nations whose economies it has lifted, and the companies that reduced costs by buying abroad. The swing away will be less favorable in those regards, but it may (a) improve importers' security, (b) increase the competitiveness of onshore producers and the number of domestic manufacturing jobs, and (c) create investment opportunities in the transition.

For how long will the pendulum swing away from globalization and toward onshoring? The answer depends in part on how the current situations are resolved and in part on which force wins: the need for dependability and security or the desire for cheap sourcing.

* * *

In complex fields like economics and geopolitics, there are few easy decisions – just choices, many of them very difficult. There are too many moving parts, too many unknowns, and too many pros and cons whose merits can't be weighed quantitatively. What sits on either side of the scale doesn't necessarily change much, but the pendulum swings radically in terms of how those things are viewed and weighted in the decision.

Here's what I wrote in *On Regulation* concerning the swing of the pendulum toward and away from regulation of the financial markets:

> It's my belief that because both free markets and regulation are imperfect – and because of the strength of people's political and philosophical biases – we will never settle permanently on either a completely free market or a thoroughly regulated system. Any position will prove merely temporary, and the pendulum will continue to swing toward one end of the spectrum and then back toward the other.

If you substitute the words "offshoring" and "domestic sourcing" for "free markets" and "regulation," then this passage just as accurately describes the choice between the cheapest sourcing and the most secure sourcing. **This absence of perfect, permanent solutions is characteristic of pendulums – it's why they swing.** And after many decades of globalization and cost minimization, I think we're about to find investment opportunities in the swing toward reliable supply.

March 23, 2022

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Memo to: Oaktree Clients

From: Howard Marks

Re: Bull Market Rhymes

While I employ a great many adages and quotes in my writings, my main go-to list consists of a relatively small number. One of my favorites is widely attributed to Mark Twain: "History doesn't repeat itself, but it does rhyme." It's well documented that Twain used the first four words in 1874, but there's no clear evidence that he ever said the rest. Many others have said something similar over the years, and in 1965 psychoanalyst Theodor Reik said essentially the same thing in an essay titled "The Unreachables." It took him a few more words, but I think his formulation is the best:

> There are recurring cycles, ups and downs, but the course of events is essentially the same, with small variations. It has been said that history repeats itself. This is perhaps not quite correct; it merely rhymes.

The events of investment history don't repeat, but familiar themes do recur, especially behavioral themes. It's these that I study.

In the last two years, we've seen dramatic examples of the ups and downs Reik wrote about. And I've been struck by the reappearance of some classic themes in investor behavior. They'll be the topic of this memo.

I want to mention up front that this memo has nothing to do with assessing the markets' likely direction from here. Bullish behavior came out of the pandemic-related bottom of March 2020; since then, significant problems have developed inside the economy (inflation) and outside (Ukraine); and there's been a significant correction. **No one, including me, knows what the sum of those things implies for the future.**

I'm writing only to place recent events in the context of history and point out a few implied lessons. This is important, because **we have to go back 22 years – to before the bursting of the tech-media-telecom bubble in 2000 – to see what I consider a real bull market and the ending of the resultant bear market**, and I imagine many of my readers entered the investment world too late to have experienced that event. You may ask, "What about the market gains that preceded the Global Financial Crisis of 2008-09 and the pandemic-related collapse of 2020?" In my view, in both cases, the preceding appreciation was gradual, not parabolic; it wasn't driven by overheated psychology; and it didn't take stock prices to crazy heights. Moreover, high stock prices weren't the cause of either crisis. The excesses in the former lay in the housing market and the creation of securities backed by sub-prime mortgages, and the latter collapse was a consequence of the arrival of Covid-19 and the government's decision to shut down the economy to limit the spread of the disease.

When I refer above to "a real bull market," I'm not talking about standard definitions such as these from *Investopedia*:

- A period of time in financial markets when the price of an asset or security rises continuously
- A situation in which stock prices rise by 20%, usually after a drop of 20%

The first of these is too bland, failing to capture a bull market's emotional essence, and the second attempts false precision. A bull market shouldn't be defined as a percentage price movement. **For me, it's best described by what it feels like, the psychology behind it, and the behavior that psychology leads to.**

(I started investing before the development of numerical criteria for bull and bear markets, and I consider such yardsticks meaningless. Take a look, for example, at a couple of recent newspaper articles. On May 20, the S&P 500 Index's decline from the top passed the "magic" 20% threshold; thus on May 21 the *Financial Times* wrote, "Wall Street stocks slumped into a bear market yesterday . . ." But because a late rally reduced the final decline to just under 20%, the headline of the same day's *New York Times* read, "S&P 500 Drops . . . but Evades Bear Market." Does it really matter whether the S&P 500 is down 19.9% or 20.1%? I prefer the old-school definition of a bear market: nerve-racking.)

<u>Excesses and Corrections</u>

My second book is *Mastering the Market Cycle: Getting the Odds on Your Side*. It's well known that I'm a student of cycles and a believer in cycles. I've lived through (and been schooled by) several significant cycles during my years as an investor. I believe understanding where we stand in the market cycle can give us a hint regarding what's coming next. And yet, when I was about two-thirds of the way through writing that book, a question dawned on me that I hadn't considered before: **Why do we have cycles?**

For example, if the S&P 500 has returned just over 10% a year on average over the 65 years since it assumed its present form in 1957, why doesn't it just return 10% every year? And updating a question I asked in my memo <u>*The Happy Medium*</u> (July 2004), why has its annual return been between 8% and 12% just six times during this period? Why is it so far from the mean 90% of the time?

After pondering this question for a while, I landed on what I consider the explanation: excesses and corrections. If the stock market was a machine, it might be reasonable to expect it to perform consistently over time. **Instead, I think the substantial influence of psychology on investors' decision-making largely explains the market's gyrations.**

When investors turn highly bullish, they tend to conclude that (a) everything's going to go up forever and (b) regardless of what they pay for an asset, someone else will come along to buy it from them for more (the "greater-fool theory"). Because of the high level of optimism:

- Stock prices rise faster than company profits, soaring well above fair value (**excess to the upside**).
- Eventually, conditions in the investment environment disappoint, and/or the folly of the elevated prices becomes clear, and they fall back toward fair value (**correction**) and then through it.
- The price declines generate further pessimism, and this process eventually causes prices to far understate the value of stocks (**excess to the downside**).
- Resultant buying on the part of bargain-hunters causes the depressed prices to recover toward fair value (**correction**).

The excess to the upside makes for a period of above average returns, and the swing toward excess on the downside makes for a period of below average returns. There can be many other factors at work, of course, but in my view, "excesses and corrections" covers most of the ground. We saw a number of excesses to the upside in 2020-21, and now we're seeing corrections thereof.

Bull Market Psychology

In a bull market, favorable developments lead to price rises and lift investor psychology. Positive psychology induces aggressive behavior. Aggressive behavior leads to higher prices. Rising prices encourage rosier psychology and further risk-taking. This upward spiral is the essence of a bull market. When it's underway, it feels unstoppable.

We saw a classic collapse of asset prices in the early days of the pandemic. For example, the S&P 500 reached a then-all-time high of 3,386 on February 19, 2020 before falling by one-third in just 34 days to a low of 2,237 on March 23. After that, a number of forces combined to produce massive price gains:

- The Federal Reserve cut the fed funds rate to roughly zero, and the Fed was joined by the Treasury in announcing massive stimulative measures.
- These actions convinced investors that these institutions would do whatever it took to stabilize the economy.
- The interest rate cut significantly reduced the prospective returns required to make investments look attractive in relative terms.
- The combination of these factors forced investors to bear risks they had been running from just a short time earlier.
- Asset prices rose: by late August, the S&P 500 had retraced its decline and surpassed its February high.
- The FAAMGs (Facebook, Amazon, Apple, Microsoft and Google), software stocks, and other tech stocks rose dramatically, pushing the market higher.
- **Eventually, investors concluded – as they often do when things are going well – that they could expect more of the same.**

The most important thing about bull market psychology is that, as cited in the final bullet point above, most people take rising stock prices as a positive sign of things to come. Many are converted to optimism. Relatively few suspect that the gains to date might have been excessive and borrowed from future returns and that they presage reversal, not continuation.

That reminds me of another of my favorite adages – one of the first ones I learned, roughly 50 years ago – "the three stages of a bull market":

- the first, when a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone concludes that things will get better forever.

It's interesting to note that even though the market moved from despondent in March 2020 to booming in May, largely thanks to the Fed, the most frequent attitude I encountered during that period was dubiousness. And the question I was asked most frequently was "If the environment is so bad – with the pandemic raging and the economy shuttered – isn't it wrong for the market to rise?" It was hard to find any optimists. Many of the buyers were what my late father-in-law used to call "handcuff volunteers": they didn't buy because they wanted to; they bought because they had to, since the return on cash was so low. And once markets started to rise, people were afraid of being left behind, so they chased prices higher. Thus, the market gains seemed to be the result of the Fed's manipulation of the capital markets, rather than positive corporate developments or optimistic psychology. It was only around the end of 2020 – when the S&P 500 was up by 16.3% for the year and 67.9% from the March bottom – that investor psychology caught up with the booming stock prices.

The bull market of 2020 was unprecedented in my experience, in that there was essentially no first stage and very little of the second. Many investors went straight from hopeless in late March to highly optimistic later in the year. **This is a great reminder that, while some themes do recur, it's a big mistake to expect history to repeat exactly.**

<u>Optimistic Rationales, Super Stocks, and the New, New Thing</u>

Raging bull markets are examples of mass hysteria. At the extreme, thinking and thus behavior become unmoored from reality. In order for this to occur, however, there has to be some factor that activates investors' imagination and discourages prudence. Thus, special attention should be paid to an element that almost always characterizes bull markets: a new development, invention or justification for the rising stock prices.

Bull markets are, by definition, characterized by exuberance, confidence, credulousness, and a willingness to pay high prices for assets – all at levels that are shown in retrospect to have been excessive. History has generally shown the importance of keeping these things in moderation. For that reason, the intellectual or emotional rationale for a bull market is often based on something new that history can't be used to discount.

Those last six words are very important. History amply demonstrates that when (a) markets exhibit bullish behavior, (b) valuations become excessive, and (c) the latest thing is accepted without hesitation, the consequences are often very painful. Everyone knows – or should know – that parabolic stock market advances are generally followed by declines of 20-50%. Yet those advances occur and recur, abetted by what I learned in high school English class to call "the willing suspension of disbelief." Here's another of my very favorite quotes:

> 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, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. 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 the insight to appreciate the incredible wonders of the present.** (John Kenneth Galbraith, *A Short History of Financial Euphoria*, 1990 – emphasis added)

I've shared that quote with readers many times over the last 30 years – since I think it so beautifully sums up a number of important points – but I haven't previously shared my explanation for the behavior it describes. **I don't think investors are actually forgetful. Rather, knowledge of history and the appropriateness of prudence sit on one side of the balance, and the dream of getting rich sits on the other. The latter always wins. Memory, prudence, realism, and risk aversion would only get in the way of that dream. For this reason, reasonable concerns are regularly dismissed when bull markets get going.**

What appears in their place is often intellectual justifications for valuations that exceed historical norms. On October 11, 1987, Anise Wallace described this phenomenon in an article in *The New York Times* titled "Why This Market Cycle Isn't Different." Optimistic thinking was being embraced at the time to justify unusually high stock prices, but Wallace said it wouldn't hold:

The four most dangerous words in investing are “this time it’s different,” according to John Templeton, the 74-year-old mutual fund manager. At stock market tops and bottoms, investors invariably use this rationale to justify their emotion-driven decisions.

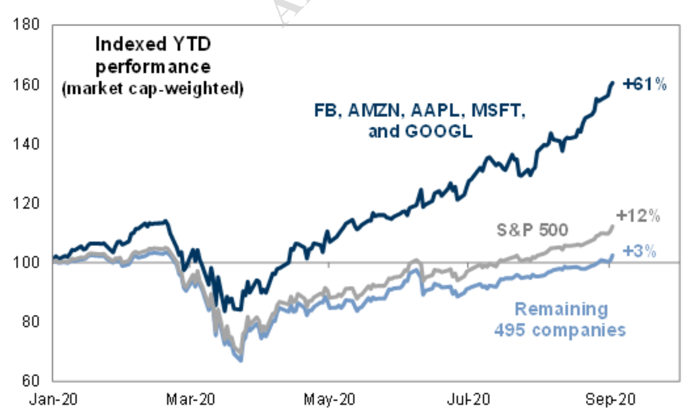
Over the next year, many investors are likely to repeat those four words as they defend higher stock prices. But they should treat them with the same consideration they give “the check’s in the mail.” No matter what brokers or money managers say, bull markets do not last forever.

It didn’t take a year. Just eight days later, the world experienced “Black Monday,” when the Dow Jones Industrial Average dropped by 22.6% in a single day.

Another justification for bull markets is often found in the belief that certain businesses are guaranteed to enjoy a terrific future. This applies to the Nifty-Fifty growth companies in the late 1960s; disc drive manufacturers in the ’80s; and telecom, Internet and e-commerce companies in the late ’90s. **Each of these developments was believed to be capable of changing the world, such that the past realities of business need not constrain investors’ imaginations and willingness to pay up.** And they did change the world. Nevertheless, the highly elevated asset valuations they were thought to justify didn’t hold.

In many bull markets, one or more groups are anointed as what I call “super stocks.” **Their rapid rise makes investors increasingly optimistic. In the circular process that often characterizes the markets, this rising optimism takes the stocks to still-higher prices. And some of this positivity and appreciation reflects favorably on other groups of securities – or all securities – through relative-value comparisons and/or because of the general improvement in investors’ mood.**

Topping the list of companies that fed investors’ excitement in 2020-21 were the FAAMGs, whose level of market dominance and ability to scale had never been seen before. The dramatic performance of the FAAMGs in 2020 attracted the attention of investors and supported a widespread swing toward bullishness. By September 2020 (that is, within six months), these stocks had nearly doubled from their March lows and were up 61% from the beginning of the year. Notably, these five stocks are heavily weighted in the S&P 500, so their performance resulted in a good overall gain for the index, but this distracted attention from the far-less-impressive performance of the other 495 stocks. The performance of the super stocks inflamed investors’ ardor, enabling them to disregard worries regarding the persistence of the pandemic or other risks.



Source: Goldman Sachs

The raging success of the FAAMGs created a luster that reflected positively on tech stocks in general. Demand soared for stocks in the sector and, as is usual in the investment world, strong demand encouraged and enabled supply. One notable barometer in this case is the attitude toward IPOs from unprofitable companies. Prior to the tech bubble of the late 1990s, IPOs from companies that didn't make money were relatively rare. They became the norm during the bubble, but their number sunk again thereafter. In the 2020-21 bull market, IPOs from unprofitable companies experienced a big resurgence, as investors easily made allowance for tech companies' desire to scale and biotech companies' need to spend on drug trials.

If companies with bright futures provide fuel for bull markets, things that are new to the markets can supercharge market excesses. SPACs are a great recent example. Investors gave these newly formed vehicles blank checks for acquisitions on the proviso that investors could get their money back with interest (a) if no acquisition was consummated within two years or (b) if investors didn't like the acquisition that was proposed. This seemed like a "no-lose proposition" (three of the most dangerous words in the world), and the number of SPACs organized soared from just 10 in 2013 and 59 in 2019 to 248 in 2020 and 613 in 2021. Some produced big profits, and in other cases investors took back their money with interest. But the lack of skepticism surrounding this relatively untested innovation – fueled by bull market psychology – allowed too many SPACs to be created, by competent and incompetent organizers alike who would be highly paid for pulling off an acquisition . . . any acquisition.

Today, the average SPAC that de-SPAC-ed since 2020 by completing an acquisition (in each case, with the approval of its investors) is selling at $5.25, versus its issue price of $10.00. This is a good example of a new thing that turned out to be less dependable than investors – who fell once again for a can't-lose silver bullet – had thought. SPACs' defenders argue that these vehicles are just an alternative way to take companies public, but their potential usefulness isn't my concern. I'm focused on how readily investors embraced an untested innovation in hot times.

Another dynamic involving novel factors deserves mention, since it exemplifies the way "the new thing" can contribute to bull markets:

- Robinhood Markets began offering commission-free trading in stocks, ETFs and cryptocurrencies in the years before the pandemic. Once the Covid-19 crisis hit, this encouraged people to "play the stock market," as casinos and sports events were closed for betting.
- Generous stimulus checks were sent to millions who hadn't lost their jobs, meaning many people saw their disposable income rise during the pandemic.
- Bulletin boards like Reddit turned investing into a social activity for people shut in at home.
- As a result, large numbers of novice retail investors were recruited online, many of whom lacked the experience needed to know what constitutes investment merit.
- Newcomers were stirred by a popular cult figure who said, "stocks only go up."
- As a result, many tech and "meme stocks" soared.

The final element worth discussing is cryptocurrency. Proponents of Bitcoin, for example, cite its variety of uses, as well as the limited supply relative to the potential demand. Skeptics, on the other hand, point to Bitcoin's lack of cash flow and intrinsic value and thus the impossibility of assigning a fair price. Regardless of which side will turn out to be right, Bitcoin satisfies some characteristics of a bull market beneficiary:

- It's relatively new (although it has been around for 14 years, it's been in most people's consciousness for only five).
- It enjoyed a dramatic price spike, rising from $5,000 in 2020 to a high of $68,000 in 2021.
- And it's certainly something that, per Galbraith, prior generations "do not have the insight to appreciate."
- In all these regards, it perfectly satisfies Galbraith's description of something "hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial . . . world."

Bitcoin is off a little more than half from its 2021 high, but others among the thousands of cryptocurrencies that have been created have declined much more.

The striking performance of the FAAMGs, tech stocks generally, SPACs, meme stocks and cryptocurrencies in 2020 reinforced the craze for them and added to investors' general optimism. **It's hard to imagine a full-throated bull market arising in the absence of something that's never been seen or heard before.** The "new, new thing" and belief that "this time it's different" are shining examples of recurring bull market themes.

<u>The Race to the Bottom</u>

Another bull market theme that rhymes from cycle to cycle is the deleterious impact of bull market trends on the quality of investors' decision-making. In short, when burning optimism takes over from levelheadedness:

- asset prices rise,
- greed grows relative to fear,
- fear of missing out replaces fear of losing money, and
- risk aversion and caution evaporate.

It's essential to bear in mind that it's risk aversion and the fear of loss that keep markets safe and sane. The developments listed above typically combine to lift markets, drive out cautious investigation and deliberation, and make the markets a dangerous place.

In my 2007 memo <u>*The Race to the Bottom*</u>, I explained that when there's too much money in the hands of investors and providers of capital and they're too eager to put it to work, they bid too aggressively for securities and the chance to lend. Their spirited bidding drives down prospective returns, drives up risk, weakens security structures, and reduces the margin for error.

- The cautious investor, sticking to her guns, says, "I insist on 8% interest and strong covenants."
- Her competitor responds, "I'll accept 7% interest and demand fewer covenants."
- The least disciplined, not wanting to miss the opportunity, says, "I'll settle for 6% interest and no covenants."

This is the race to the bottom. This is why it's often said that "the worst of loans are made in the best of times." This is something that can't happen when people are smarting from recent losses and afraid of experiencing more. It's not a coincidence that the record-long 10-plus-year economic recovery and stock market rise that followed the Fed's massive response to the Global Financial Crisis were accompanied by:

- a wave of IPOs from money-losing companies;
- record issuance of sub-investment grade securities, including risky CCC-rated debt;
- debt issuance from companies in volatile industries such as tech and software that lenders are likely to shun in more cautious times;
- rising valuation multiples on acquisitions and buyouts; and
- shrinking risk premiums.

Favorable developments also encourage the increased use of leverage. Leverage magnifies gains and losses, but in bull markets, investors feel sure of gains and disregard the possibility of loss. Under such conditions, few can see a reason not to incur debt – with its piddling interest cost – to increase the payoff from their successes. But putting more debt on investments made at high prices late in the up-cycle is no formula for success. When times turn bad, leverage turns disadvantageous. And when investment banks issue late-cycle debt that they can't place with buyers, they're stuck with it. Debt "hung" on banks' balance sheets is often a "canary in the coal mine" with regard to what's in store.

Since I'm relying on time-worn investment adages, it's appropriate at this point to invoke the one I consider the greatest regarding investor behavior over cycles: "What the wise man does in the beginning, the fool does in the end." People who buy in stage one of a bull market, when prices are low because of prevailing pessimism (such as during the Global Financial Crisis of 2008-09 and in the early days of the Covid-19 pandemic in 2020), have the potential to earn high prospective returns with little risk: the main prerequisites are money to spend and the nerve to spend it. **But when bull markets heat up and good returns encourage investors' optimism, the traits that are rewarded are eagerness, credulousness, and risk-taking. In stage three of a bull market, new entrants buy aggressively, keeping it aloft for a while. Caution, selectivity, and discipline go out the window just when they're needed most.**

Particularly noteworthy is the fact that investors who are in a good mood and being rewarded for risk tolerance typically cease to practice discernment regarding investment opportunities. Not only do investors consider it a certainty that some examples of "the new thing" will succeed, but eventually they conclude that everything in that sector will do well, so differentiating is unnecessary.

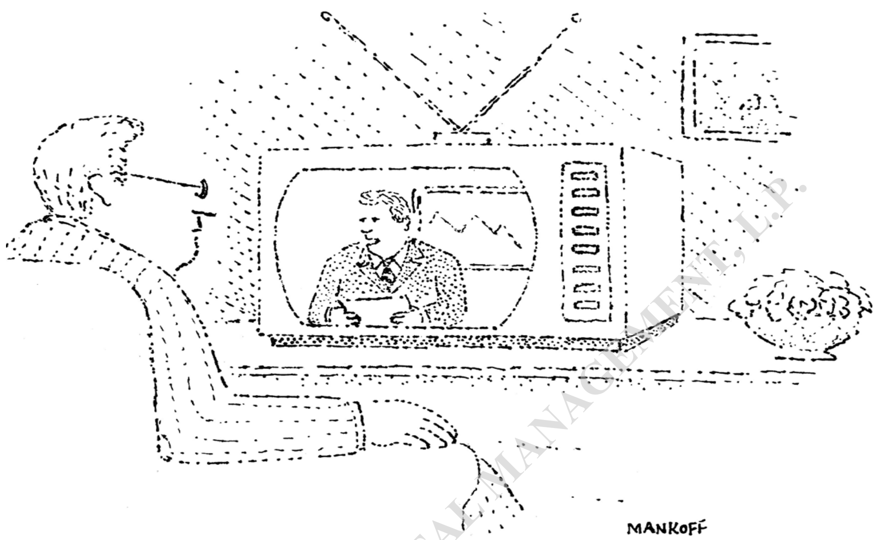
Because of all the above, the term "bull market psychology" isn't a positive. It connotes carefree behavior and a high level of risk tolerance, and investors should find it worrisome, not encouraging. As Warren Buffett puts it, "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." Investors have to know when bull market psychology is in ascendance and apply the required caution.

The Pendulum Swings

Bull markets don't arise out of thin air. The winners in each bull market are winners for the simple reason that a grain of truth underlies their gains. However, the bullishness I've described above tends to exaggerate the merits and pushes security prices to levels that are excessive and thus vulnerable. And the upward swing doesn't last forever.

In *On the Couch* (January 2016), I wrote, "in the real world, things generally fluctuate between 'pretty good' and 'not so hot.' But in the world of investing, perception often swings from 'flawless' to 'hopeless.'" The way things are seriously overdone in the markets is one of the key characteristics of investor behavior. During bull markets, investors conclude that difficult, unlikely, and unprecedented things are sure to work. But in less ebullient times, favorable economic news and "earnings beats" fail to inspire buying, and rising prices no longer make life painful for people who are underinvested. Thus, we stop seeing the willing suspension of disbelief, and psychology flips to negativism.

The key lies in the fact that investors are capable of interpreting virtually any piece of news either positively or negatively, depending on how it's reported and on their mood. (The cartoon below, one of my all-time favorites, was published many decades ago – check out those rabbit ears and the depth of the TV set – but clearly the caption is relevant to this very moment.)



"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."

Reflecting the "flawless-to-hopeless" progression I mentioned earlier, prevailing narratives are subject to reversal. While the argument supporting the bull market may have been reasonably likely to hold, investors treated it as ironclad when all was going well. When some of the argument's flaws come to light, however, it's dismissed as all wrong.

- In the happy season (all of a year ago), the tech bulls said, "You have to buy growth stocks for their decades of potential earnings increases." But now, after a significant decline, we instead hear, "Investing based on future potential is too risky. You have to stick to value stocks for their ascertainable present value and reasonable prices."
- Likewise, in the heady times, participants in IPOs of money-losing companies said, "There's nothing wrong with companies that report losses. They're justified in spending to scale up." But in the present correction, many say, "Who would invest in unprofitable companies? They're just cash incinerators."

People who haven't spent much time watching markets may believe that asset prices are all about fundamentals, but that's certainly not so. The price of an asset is based on fundamentals **and how people view those fundamentals**. So the change in an asset price is based on a change in fundamentals **and/or a change in how people view those fundamentals**. Company fundamentals are theoretically subject to something called "analysis" and possibly even prediction. On the other hand, **attitudes regarding fundamentals are psychological/emotional, not subject to analysis or prediction, and capable of changing much faster and more dramatically.** There are adages that capture this dimension, too:

- The air goes out of the balloon much faster than it goes in.
- It takes longer for things to happen than you thought it would, but then they happen much faster than you thought they could.

As for the latter, in my experience, we often see positive or negative fundamental developments pile up for a good while, with no reaction on the part of security prices. But then a tipping point is reached – either fundamental or psychological – and the whole pile suddenly gets reflected in prices, sometimes to excess.

Then What Happens?

Bull markets don't treat all sectors the same. In bull markets, as I discussed earlier, optimism coalesces most powerfully around certain groups of securities, such as "the new thing" or "super stocks." These rise the most, become emblematic of the bull in this period, and attract further buying. The media pay these sectors the most attention, extending the process. In 2020-21, the FAAMGs and other tech stocks were the best examples of this phenomenon.

It goes without saying – but I'll say it anyway – that investors holding large amounts of the things that lead in each bull market do very well. And fund managers who are smart enough or lucky enough to be dedicated exclusively to those things report the highest returns while optimism prevails and show up on the front page of newspapers and on cable TV shows**. In the past, I've said our business is full of people who got famous for being right once in a row. That can go double for fund managers who are smart or lucky enough to be overweight the sectors that lead a bull market.**

However, the stocks that rise the most in the up years often experience the greatest declines in the down years. The applicable adages here are from the real world, but that doesn't reduce their relevance: "live by the sword, die by the sword;" "what goes up must come down;" and "the bigger they are, the harder they fall":

- One tech fund rose by 157% in 2020, moving from obscurity to fame. But it lost 23% in 2021 and is down another 57% so far in 2022. $100 invested at year-end 2019 was worth $257 a year later, but that's down to $85 today.
- Another tech fund, somewhat less volatile, was up by 48% in 2020 but is down by 48% since. Unfortunately, up 48% and down 48% don't combine to produce zero change, but rather a net decline of $22 per $100 invested.
- A third tech fund was up a startling 291% in year one, but it fell by 21%, 60%, and 61% in the three years that followed. $100 invested at the beginning of this four-year period was worth $43 at the end, a decline of 89% from the end of that incredible first year. But wait a minute: there haven't been four years in the current boom/bust. No, the results I cite are from 1999-2002, when the last tech bubble inflated and collapsed. I include them only as a reminder that the current performance pattern is a recurrence.

Earlier I mentioned Robinhood, the originator of commission-free trading. It epitomized the role of the digital in the 2020-21 bull market. Robinhood went public in July 2021 at $38, and over the next week, the stock price shot up to $85. Today it's at $10, an 88% drop from the high in less than a year.

But the equity averages aren't doing that badly, right? The tech-heavy Nasdaq Composite is "only" down 27.4% in 2022. One of the characteristics of this bull market is that the biggest companies' stocks – which are the most heavily weighted – have done the best, buoying the indices. Consider what that implies for the rest; 22% of Nasdaq stocks are down at least 50%. (Data here and below are as of May 20.)

Here are the declines from the top of some well-known tech/digital/innovation stocks that I picked at random. Maybe there are a few here that, when they were at their peak, you kicked yourself for not having bought:

PayPal	-57%
Beyond Meat	-63
Coinbase	-74
Salesforce	-37
Carvana	-86
DocuSign	-50
Moderna	-46
Netflix	-69
Shopify	-74
Spotify	-54
Uber	-44
Zoom	-51
Average	-59%

Let's say you still believe market prices are set by a consensus of intelligent investors on the basis of fundamentals. If that's the case, then why are all these stocks down by such large percentages? And do you really believe the value of these businesses has more than halved on average in the last few months? This line of inquiry leads to something else I think about often. On days when the stock market makes its biggest moves, Bitcoin often moves in the same direction. Is there any fundamental reason why the two should be correlated? The same goes for international links: when Japan starts off the day with a big decline, Europe and the U.S. often follow suit. And sometimes it seems U.S. stocks lead and it's Japan that falls in line. Are these countries' fundamentals connected enough to justify co-movement?

My answer to all these questions is generally "no." The common thread isn't fundamentals: it's psychology, and when the latter changes significantly, all of these things are similarly affected.

The Lessons

As always for students of investing, what matters most isn't what events transpired in a given period of time, but what we can learn from these events. And there's a lot to be learned from the trends in 2020-21 that rhymed with those in previous cycles. In bull markets:

- Optimism builds around the things that are doing spectacularly well.
- The impact is strongest when the upswing arises from a particularly depressed base in terms of psychology and prices.
- Bull market psychology is accompanied by a lack of worry and a high level of risk tolerance, and thus highly aggressive behavior. Risk-bearing is rewarded, and the need for thorough diligence is ignored.

- High returns reinforce belief in the new, the unlikely, and the optimistic. When the crowd becomes convinced of those things' merit, they tend to conclude "there's no price too high."
- These influences cool eventually, after they (and prices) have reached unsustainable levels.
- Elevated markets are vulnerable to exogenous events, like Russia's invasion of Ukraine.
- The assets that rose the most – and the investors who over-weighted them – often experience painful reversals.

These are themes I've seen play out numerous times during my career. None of them relates exclusively to fundamental developments. Rather, their causes are largely psychological, and the way psychology works is unlikely to change. **That's why I'm sure that as long as humans are involved in the investment process, we'll see them recur time and time again.**

And, as a reminder, since the major ups and downs of the markets are primarily driven by psychology, it's clear that market movements can only be predicted, if ever, when prices are at absurd highs or lows.

May 26, 2022

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Memo to: Oaktree Clients

From: Howard Marks

Re: Conversation at Panmure House

I recently was asked by Patrick Schotanus of Edinburgh Business School to participate in their inaugural symposium on the subject of cognitive economics. The symposium took place at Panmure House, the final residence of the great economist Adam Smith, and the theme was the Market Mind Hypothesis (MMH), which Patrick developed. I spent an hour recording a video interview with him, which on May 24 was shown at the symposium and followed by a live question-and-answer session. We then used software to create a transcript of the taped interview. I've edited it only to make my remarks more intelligible and less painful to read (without changing their message); any serious additions are shown in brackets.

While little of my content is totally new (in fact, you might recognize some thoughts that I went on to incorporate in *Bull Market Rhymes*), it seems only right to share it with Oaktree's clients because it's never all been presented in one place before. I hope you'll find something worthwhile in the conversation.

* * *

Patrick Schotanus: *Hello, Howard. Thank you first of all for participating in our symposium by way of this fireside interview, in which we'll discuss some of your memos as well as other reflections that you've shared with investors over the years. For the benefit of our multidisciplinary audience, I'll introduce some of these questions with some explanatory background, especially from a cognitive angle. So I'd like to start with a few questions by MMH team members. The first one is from James Clunie:*

You often write about the concept of the pendulum. More recently, in a podcast, you applied it to international affairs. While the pendulum appears at first glance to be a mechanical model, importantly, you have also applied it to human psychology, especially mood swings. These fit much more with a spontaneous "market mind," which you have also referred to, for example, in your memo You Can't Predict. You Can Prepare. *Consequently, the question is, in what way and to what extent is the pendulum mechanical? For example, would it be correct to say that while the pendulum implies mean reversion, the latter is not a mechanical process and is thus difficult to predict?*

> HM: Thanks for that question, Patrick. I'm very pleased to be discussing these topics with you. As you know, they're something I'm fixated on, and it's great to have someone to talk with about them. I think the pendulum is a good example of many of the things we're going to discuss today. It's an idea. It's a concept. The idea is that it's something that swings back and forth. Something that oscillates, something that fluctuates around a midpoint. That's the whole concept.

It's certainly not mechanical. In physics, I think the pendulum has certain qualities, and as a result, its behavior can be predicted. But in the things I'm talking about, no. As you know, my last book, in 2018, was called *Mastering the Market Cycle*, and I talked a lot in there about the pendulum. I got a note from Nick Train of Lindsell Train in London, saying something like, "I disagree with you, Howard: this isn't a pendulum. Its movement is not regular, it's not predictable, the speed of the fluctuations varies, and their extent varies." And I said, "Nick, let's have lunch." So, when I next got to London, we sat down and I explained to him that there are multiple definitions of a pendulum. One definition says it's mechanical and thus predictable, and governed by the laws of physics. And another definition says that it's a swing."

In your question to me, Patrick, you used the term "mood swing," and I think understanding it as a mood swing is much more useful for our purposes. As this discussion progresses this morning, I think the main thrust is going to be that these things are not scientific and thus not consistent and repeatable.

PS: *Russell Napier, another member, has a related question also covering the mechanical angle. Mainstream economics, also known as mechanical economics, which partners the unlikely bedfellows of Neoclassical and Neo-Keynesian economics, views and treats the market as some automaton, in a way, that can be centrally engineered, planned, and steered. If instead we view the market as embodying our collective extended mind, acknowledging its warts and all, which obviously is our thesis, which two episodes in your career would be best suited to study the market mind?*

HM: Russell's question about the two episodes, contained in your last sentence, would limit me too much. So, if you don't mind, I'm going to go way beyond that, because I think my answer to this question is central to our whole discussion today.

Your first few words, when you discussed what Russell said, refer to the economy as mechanical, and I think that isn't helpful. Applying the word "mechanical" (again, as with the first question) suggests that it's governed by the rules of physics, the laws of nature, that it's a science, that it performs the same each time, that it's repeatable, studiable and extrapolable. And I think these are all wrong.

And in fact, I aggressively remind people that I'm not an economist, but also that economics is called the "dismal science." And I'm not sure it's a science at all, but if it is, it's certainly dismal, in the sense that it's not like physics, where if you do A, you always get B. Sometimes you get C or sometimes nothing at all. Richard Feynman, the great physicist, once said, "Physics would be much harder if electrons had feelings." You walk into a room, you throw the light switch, and the light goes on. It always goes on, because every time you throw the switch, the electrons flow from the switch to the light. They never forget to flow; they never decide to flow in a different direction; they never flow from the light to the switch. They never go on strike or complain that they're underpaid.

So, the point is that economics is not a science, in my opinion. You know, science is all about causality and predictability, and if A happens, then B is sure to happen. Well, that's certainly not true in economics. If A happens, B might <u>tend to</u> happen most of the time. That doesn't make it a science.

Now let's talk about using these concepts to refer to investing, not economics. I have a presentation that I give, called *The Human Side of Investing, or the Difference between Theory* *and Practice*. It was inspired by a quote from a great philosopher. You may know him (or maybe not, since you're mostly not Americans): Yogi Berra. Yogi was a great catcher for the New York Yankees baseball team in the 1950s – a highly skilled baseball player, but more famous today for the things he said, or maybe he didn't say them. (One of the things Yogi said is, "I never said half the things I said.")

But anyway, he once said, supposedly, that "In theory there's no difference between theory and practice, but in practice there is." And to me, that's the essence of this answer to you. It's the essence of my work, and in my opinion, it should be the essence of your work and that of your colleagues at this conference.

What we learn in school, in my opinion, and what we <u>should</u> learn in school, is how things are supposed to work. That goes for the economy, and that goes for the markets. However, the teachers might also help by adding, ". . . but it doesn't always work that way. That's a framework; that's a thought model. It certainly doesn't govern all the time." And that's the key. Using the term "mechanical" to refer to the economy – or to the markets – is describing the way things are supposed to work. The "psychological" or "behavioral" is all about the way things <u>do</u> work. And there's a big difference between the two.

I've spent a lot of my career trying to reconcile the two: the things I learned as a student at the University of Chicago's Graduate School of Business 55 years ago and the things I've experienced in the markets since then.

I was introduced to the concept of the efficient market hypothesis and so forth back at Chicago. I was very fortunate: those things were developed there mostly, I think, between '62 and '64. I got there in '67, so by definition I was in one of the first classes taught these things, and it was very helpful to me. Not in the sense that the Chicago School of thought should govern your actions, but it should inform them. And, as I say, I've worked hard to reconcile this education with what I saw later.

As an undergraduate, I went to Wharton, which was entirely qualitative and pragmatic. Then I went to Chicago, which was entirely quantitative and theoretical. At Chicago, most of the professors dismissed anything that was qualitative and pragmatic or "real world." But I took a course in investing from James Lorie, who co-headed the Center for Research in Security Prices. His course was derided as "Lorie's Stories," because he would bring in actual practitioners every couple of weeks to talk about what they did, and that was considered heresy at Chicago. The final examination consisted of one question: "You've learned the theory at Chicago, how do you square that with real world considerations?" I think that's the key.

In the late '90s, I wrote a memo called *<u>What's It All About, Alpha?</u>* You may recall that there was a movie called *Alfie;* I think it starred Michael Caine (it was a long time ago, maybe 40-50 years ago). It had a theme song, "What's It All About, Alfie?", sung by Dionne Warwick. Wonderful song. I borrowed the title and changed it to "Alpha" for a memo talking about reconciling the Chicago theory, and in particular the efficient market hypothesis, with the real world. In there, I stated my view that the hypothesis says that because of the concerted actions of so many investors, security prices are "right," meaning investors price securities so that you can expect a fair risk-adjusted return, no more, no less. Again, that's how it's supposed to work, but certainly not how it does work.

I think I said in the conclusion of that memo that if you ignore the efficient market hypothesis, you're going to be very disappointed, because you're going to find out that very few of your active investment decisions work. But if you swallow it whole, you won't be an investor, and you'll give up on active success. So the truth, if there is one, has to lie somewhere in between, and that's what I believe.

PS: *In fairness to Russell, it was in my introduction to Russell's question [i.e., not in Russell's question itself] that I said the economy is mechanical and that's the definition of mainstream economics. Russell and I do not necessarily agree on that. But to continue on mechanical economics as a theory: In your memo* On the Couch, *you talk about your own early exposure to the efficient-market-type classes. For the audience, EMH is based on the rational expectations hypothesis; EMH states that markets are rational because any pockets of irrationality are averaged away [i.e., the errors made by the group become smaller than those made by individuals]. In contrast, you also highlight the reality of irrationality that can be observed in markets, something that both Alan Greenspan and Robert Shiller called "irrational exuberance." Later, the GFC, or the Global Financial Crisis, painfully hit home that what seems rational for an individual can be dangerously irrational if done collectively. So my first question is, can we square this circle? For example, is irrationality just about semantics, or is it something real that not only exists, but because of the collective dynamic, can actually threaten the economic system and may thus not necessarily be averaged away?*

HM: To me, Patrick, the answer lies in my view of the efficient market hypothesis. Again, the efficient market hypothesis says that due to the concerted actions of so many investors, who are intelligent and numerate and computerized and informed and highly motivated and rational and objective and willing to substitute A for B, prices for securities are right, such that they presage a fair risk-adjusted return. I believe that's the definition.

But you get into a problem, because when I listed off the qualities that are necessary for a market to be efficient, I snuck in there the economist's notion of the perfect market and its requirement that the participants be rational and objective. And in investing, they're not. That's really the point.

"Economic man" is supposed to make all these decisions in a way that optimizes wealth. But she often doesn't, because she's not always objective and rational. She has moods. And those moods interfere with this arriving at the right price. So my definition of the efficient market hypothesis is that because of the concerted efforts of all the participants, the price at a given point in time is as close to right as those people can get. And because it's as close to right as most of them can get, it's very hard to outperform the market by finding errors – what theory calls "inefficiencies" and I just think of as "mistakes."

Sometimes prices are too high. Sometimes prices are too low. But because the price reflects the collective wisdom of all investors on that subject, very few of the individuals can identify those mistakes and profit from them. And that's why active investing doesn't consistently work, in my opinion. I think my version of the efficient market hypothesis makes it roughly just as hard for active managers to beat the market as does the strong form of the hypothesis, that everything's always priced right. But I think mine is more reflective of reality. I wrote in one of my memos – maybe it was *What's It All About, Alpha?* – about a stock that was $400 in 2000 and $2 in 2001. Now it's possible – but to me it's unlikely – that both of those observations were "right." Rather, I think they merely reflected the consensus of opinion at the time.

This business – I shouldn't say "this business"; that sounds derogatory – the idea that inefficiencies will be arbitraged away by the operations of the market ignores one of the key elements that I think describes reality, and that is mass hysteria. And I think the markets – economies too, but more importantly the markets – are subject to mass hysteria.

I think it was in *On the Couch* that I said, "in the real world, things fluctuate between pretty good and not so hot. But in the markets, they go from flawless to hopeless." Just think about that one sentence. If it's true – and I believe it's true – that shows you the error, because nothing is flawless and nothing is hopeless. But markets, I believe, treat things as flawless and hopeless, and there's the error.

The book I mentioned, *Mastering the Market Cycle* (I'm going to keep repeating the title in the hope that everybody will buy a copy) . . . You know, I'm a devotee of cycles. I'm a student of cycles. I've lived through a half a dozen important cycles in my career. I've thought about them. I think they dominate what I do. And I got about two-thirds of the way through writing that book and something dawned on me, a question: Why do we have cycles?

The S&P 500 – I mentioned Jim Lorie – the Center for Research in Security Prices told us almost 60 years ago, that from 1928 to '62, the S&P 500 had returned an average of 9.2% a year. Things have been better since then, and I think if you go back and look at the whole last 90 years, it's 10½% a year, the return on the S&P 500.

Here's a question: Why doesn't it just return 10½% every year? Why sometimes up 20% and sometimes down 20%, and so forth? In fact – and I included this factoid in one of my memos – it's almost never up between 8% and 12%. So if the average return is 10½%, why isn't the return clustered around 10½%? Why is it clustered outside the central range? I think the answer is mass hysteria.

And by the way, the same is true of the economy and mainstream economics, which of course you described as mechanical, and I think that many people would describe as mechanical. But, certainly, economics is driven by decisions made by people, who are not always rational and objective. Maybe in theory they're closer than investors to being rational and objective, but still they're not always.

But anyway, my explanation for the occurrence of cycles is "excesses and corrections." You have a secular trend or a "normal" statistic. Let's say it's the secular trend of the S&P 500. Sometimes, people get too excited. They buy the stocks too enthusiastically. The prices rise. They rise at more than a 10½% annual rate until they get to a price that is unsustainable. And then everybody says, "No, I think they're too high." So then they correct back toward the trendline. But, of course, given the nature of psychology, they correct through the trendline to an excess on the downside. And then people say, "No, that's too low," so then they bring it back toward the trendline and through it to an excess on the high side.

So excesses and corrections: that's what cycles are about, in my opinion. Where do the excesses come from? Psychology. People get too optimistic, then they get too pessimistic. They get too greedy, then they get too fearful. They become too credulous, then they become too skeptical, and so forth. Oh, and the big one: they become too risk-tolerant, and then they become too risk-averse.

PS: If I can just follow up on that – particularly for our cognitively inclined audience – implied in this you suggest that there might be mental causality, and my next questions are basically also to motivate future research as part of economics revision. But during your September [podcast](), in which you revisit the On the Couch *memo, you talk about causality and how complex it can be. And we agree and highlight this in our work.*

For example, when Alan Greenspan, in that famous '96 "irrational exuberance" speech, mentions the complexity of the interactions of asset markets and the economy, and I'm quoting him now: "It chiefly concerns, at least in our view, this dualism of the psychological of the former and the physical of the latter." Now, saying this, mental causality is highly controversial and complex in cognitive science, but cognitive science is the area that really studies this. So, you also specifically refer to Soros's reflexivity in that context, and as you already indicated just now, but also in your memo, you equate prices almost to psychology. And finally, we've all experienced this dangerous – to the point of existential – tail-wagging-the-dog dynamic surrounding Lehman's collapse. So my first question is, if we agree that we will not gain much by identifying yet another behavioral bias, nor by running yet another regression, what would you like to see investigated by cognitive scientists that could potentially lead to more important insights, especially regarding our understanding of the interaction between these two domains of the real and financial economies?

HM: Well, the people at this symposium know much more than I do about how to get to the bottom of these things. But clearly there's so much grist for this mill. Now, exactly how you quantify mood, and so-called animal spirits and irrational exuberance, is beyond me. I always say, Patrick, and I think I said it in *Mastering the Market Cycle*, that if I could know just one thing about every security I was thinking about buying, it would be how much optimism is in the price.

When you watch TV and you hear the newsreaders talking about what happened in the stock market today, you get the impression that prices are the result of fundamentals and changes in prices are the result of changes in fundamentals. And that is vastly inadequate. (By the way, they always say, "The market went up today because of X" or "The market went down today because of Y." I always say, "Where do they go to find that out, because I haven't found it yet?" I haven't found where you go to get an explanation of the market's behavior, even after the fact.) But it's not true that it's all about fundamentals. The price of an asset is based on fundamentals <u>and how people view those fundamentals</u>. And a change in an asset price is based on the change in fundamentals <u>and the change in how people view those fundamentals</u>. So, facts and attitudes. Any research that could capture changes in attitudes, I think is important.

Now, what about quantifying these animal spirits? In one of the more jocular portions of my first book, *The Most Important Thing*, I include something I called "the poor man's guide to market assessment." I have a list of things in one column, and I have a list of things in the other column, and whichever list is more descriptive of current conditions tells you whether it's optimism or pessimism that's governing the market. There are things like, do deals get sold out or do they languish? Are hedge fund managers being welcomed on TV or not? Who does the crowd form around at cocktail parties? What is the media saying: "We're going to the moon" or "We're cratering forever"? I don't know how to quantify these things. But these are among the very important things that I listen to in order to figure out where we stand in the cycle. And I believe where we are in the cycle plays a very strong role in figuring out where we'll go next. (In fact, take the title of my second book, *Mastering the Market Cycle*. When I was thinking about writing it, it was called *Listening to the Cycle*. "Listening" in the sense of taking our signals from where we are in the cycle. "Listening" also in the sense of obeying. The publisher thought we'd sell more books if the title implied the book would help you master the market cycle.) But I, as a practical investor, try to figure out what's going on around me.

Now let's go back. I didn't do what I should have, because I didn't answer Russell Napier's real question: can I name two episodes that showed this kind of thing in action? I was glad to have the questions in advance, because it allowed me to think about the two episodes I want to propose.

In the spring of 2007, I wrote a memo called *The Race to the Bottom*. This was when the subprime mortgage mania was at its apex, I think, and when the logs had been stacked in the fireplace for the conflagration that became the Global Financial Crisis. It happens that I was driving around England in the fall of '06 – maybe November or December '06 – and I was reading the *FT* (I mean I wasn't driving and reading; I was being driven so I could read), and there was an article in the *FT* that said that, historically, the English banks had been willing to lend people three-and-a-half times their salary in a mortgage. But now, XYZ Bank announced that it was willing to lend four times your salary, and then ABC Bank said, "No, we'll lend five." And that bidding contest – to make loans by lowering credit standards – seemed to me to be a race to the bottom. And I wrote that markets are an auction place where the opportunity to make a loan, or the opportunity to buy a stock or a bond, goes to the person who's willing to pay the most for it. That is to say, get the least for his money, just like in an auction of a painting. And so, in this case, the bank that was willing to have the lowest credit standards and the weakest loans was likely to win the auction and make the loans: race to the bottom. And I said this is what happens when there's too much money in the hands of providers of capital and they're too eager to put it to work. Mood! And, of course, we all know the Global Financial Crisis ensued.

Now fast forward from February '07 to October '08: Lehman Brothers goes bankrupt on September 15, 2008, and now, rather than being carefree, the pendulum has swung, and people are terrified. Rather than seeing risk as their friend, as in, "The more risk you take, the more money you make, because riskier assets have higher returns," now people say "Risk bearing is just another way to lose money. Get me out at any price."

So the pendulum swung, and of course people's optimism collapsed, the S&P 500 collapsed, and the prices of debt collapsed. So I wrote a memo right around October the 10th of '08 – maybe that day was the all-time low for credit, I don't know exactly – that was called *The Limits to Negativism*, based on an experience I had. I needed to raise some money to delever a levered fund that we had that was in danger of melting down due to margin calls, and I went out to my clients. I got more money. We reduced the fund's debt from four times its equity to two times. Now we're again approaching the point where we can get a margin call. Now I need to delever it from two times to one time. I met with a client who said, "No, I don't want to do it anymore." And I said, "You gotta do it. These are senior loans, and the default rate on senior loans has been infinitesimal over time. There's potential for a levered return of 26% a year from what I consider incredibly safe instruments."

This client – excuse me if I belabor this, but I think it's interesting – this client said to me, "What if there are defaults?" And I said, "Well, our historical default rate on high yield bonds – which are junior to these instruments – is 1% a year. So if you start with 26% and you take off

1% for defaults, you still get 25%." So she said, "What if it's worse than that?" I said, "The high yield bond universe default rate has been 4% a year, so you're still getting 22% net." She says, "What if it's worse than that?" And I said, "The worst five years in our default experience is 7½%, and if that happens, you're still getting 19%." She says, "What if it's worse than that?", and I said, "The worst year in history is 13%. If that recurs every year for the next eight years, you'll still make 13% a year." She says, "What if it's worse than that?" And I said, "Do you have any equities?" She said, "Yes, we have a lot of equities." I said, "If we get a default rate on high yield bonds of more than 13% a year every year into the future, what happens to your equities in that environment?"

I describe myself as having run back to my office after that meeting to write that memo, *The Limits to Negativism*. What I wrote there was that it's very important when you're an investor to be a skeptic and not believe everything you hear. And most people think being a skeptic consists of dealing with excessive optimism by saying, "That's too good to be true." But when it's pessimism that's excessive, being a skeptic means saying, "That's too bad to be true." That particular investor couldn't imagine any scenario that couldn't be exceeded on the downside. So, in other words, for that person, there was no limit to negativism.

And when I conclude that the other people in the market, the people setting the market prices, are excessively negative and excessively risk averse, then I – an inherently conservative person – and my partner, Bruce Karsh, who runs our distressed debt funds – also an inherently conservative person – we go crazy spending money when we conclude there's excessive pessimism, fear, and risk aversion incorporated in asset prices [meaning they're lower than they should be]. So it's not just the mechanical aspects that determine market prices – it's psychology. It's mass hysteria, which comes in waves from time to time, that leads to market cycles that prove excessive.

PS: Before I go to my next question, I'd like to come back to your point where you say it's hard to quantify mood. But perhaps that's exactly the problem: that we're trying to capture it with analytical tools like Excel and MATHLAB. Or it is when, for example, you talk about, we need to measure the temperature of the market, and when we're perceptive, we can gauge it. And it seems to me almost like when you're trying to assess a mood in a restaurant, it's a qualitative aspect. And some people perhaps have this innate ability, whereas others would perhaps be helped with different methodologies and different tools, and we can try to grasp mood better in that way, because, nowadays, people talk about market sentiment and try to capture it by looking at the VIX or put/call ratios or things like that, which I think you would disqualify as market mood. That's not market mood.

HM: Those things are indicators or symptomatic, but they don't all move in the same direction at the same time. Sometimes A and B will go up, and C won't. Sometimes A and C will go up, but B won't. So, clearly, they're not reliable indicators, and they also can't be dealt with in a mechanical sense. But I wrote in one of my memos – I think it was *Risk Revisited Again* in 2015 – I said superior investors have a better sense for the shape of the probability distribution that will govern future stock price movements, and thus a better sense for whether the expected return justifies taking on the potential negative events that lurk in the left-hand tail. I think that's it, and there's nothing in there about measuring, Patrick, or anything mechanical.

You know, I was locked up with my son for several months during the pandemic. He and his family moved in with us, so we had a lot of time for talking. He's an optimist. (He would say he's not an optimist – that he's a realist – but of course all optimists think they're realists, and all pessimists think they're realists.) Anyway, he has an optimistic bent. He's a tech investor, a venture capitalist; he runs a VC fund; he does a fabulous job at it, and we talked about these things at great length. He made a point, which I incorporated in a memo called *Something of Value* in January of '21 about our conversations – and that's the memo that has gotten the most positive reaction of all of them over 30-plus years. He made the point that, as he puts it, because information and understanding are so widespread, so ubiquitous, "readily available quantitative information with regard to the present" cannot be depended on to produce superior returns.

This is the epitome of the efficient market hypothesis. If everybody has all the same "readily available quantitative information with regard to the present," then being a superior investor has to be a matter of going beyond that. You have to have something else. And if he's right in that description, then what are the things that can be the source of superior investing? It seems to me there are two:

- Number one: A better comprehension, if that's the right word, of the future. Some people see the future better than others, and that could do the trick, because, remember, what he says doesn't suffice is readily available quantitative information about the present. By definition, there's no information about the future, but maybe some people can see the future better than others.

- Or the other thing that could be a source of superior results is a superior ability to process qualitative information. Remember, what he described as not helpful is readily available quantitative information about the present. What about qualitative information? Qualitative information includes mood, and we've been talking about the market mood. And maybe some people have a better feeling than others for the collective psyche and for whether it's too depressed and therefore presenting great opportunities to buy or too enthusiastic and thus offering great opportunities to sell or short. [In addition to mood, qualitative information also includes things like the quality of management, the effectiveness of the company's product development capability, and the strength of its accounting.]

The point is that a superior investor has to do at least one of those two things better, and maybe both. I think that that's where the superiority comes in.

And, by the way, to take it one step further, we can ask, "How many people have a superior view of the future? And how many people have a superior understanding of the market mood [and other qualitative factors]?" And if the answer to both is "not so many," then that explains why active investing has been a flop for most people who've tried it.

PS: My next question goes in a somewhat different direction. Investing offers many dilemmas and conundrums. And specifically, to assume that things will remain roughly the same, also known as "history rhymes," may be just as dangerous as expecting change, also known as "it's different this time." Which side of the debate are you generally on and why?

HM: There's a quote widely attributed to Mark Twain: "History does not repeat, but it does rhyme." I'm a believer in that. When Twain says history doesn't repeat, what he's saying is that the causes of events vary, the consequences of events vary, the form they take varies. But there are things that do recur. For example:

- Number one: Generally speaking in the markets, when things have been going well for a few years, people become less risk-averse. When they become less risk-averse, they do riskier things. When the economy eventually turns down, those things produce outsized losses.

- Number two: When people are feeling good and things have been going well for a while, people use more leverage. And, eventually, they reach a level of leverage such that they can't survive in tough times, and they melt down when tough times arrive.

- Number three: Because borrowing for the short term is cheaper than borrowing long, people tend to borrow short for long-term projects in order to maximize the delta. But if a bad day comes when you have to refinance your short-term debts because they're due and the market is closed, you can't, and you're out of business.

These are themes that we see recur over time. Not exactly the same every time, and with different reasons from time to time. But I do think that themes − mostly relating to psychology – tend to rhyme, you know. The particulars of market mechanics, the use of different forms of fundraising, and different forms of securities – these change all the time: ETFs, algorithmic funds, index funds, senior loans, and high yield bonds. These things are innovative; they're the reflection of people's minds as applied to financial problems. But the tendencies of the human mind itself tend to rhyme over the years.

By the way, the first time I ever came across the saying you mentioned – "It's different this time" – was October the 11th of 1987. There was an article in *The New York Times* entitled "Why This Market Cycle Isn't Different." It talked about the fact that people often say it's different this time and that this saying is generally employed to explain why historical norms don't apply anymore: norms of valuation and the rhymes that I was just talking about. Anise Wallace wrote that article – it made a big impression on me – and she said, "You know what? This time it's no different; these things will eventually lead to the same outcomes as they always have." [The assertion that things were different was being used at the time to justify the very high stock market valuations. As it happens, the article ran just eight days before "Black Monday," on which the Dow Jones Industrial Average declined by 22.6% in a single day.]

Wallace mentioned that Sir John Templeton said, "About 20% of the time, things actually do change." I wrote another memo within the last two years in which I said that, given the ubiquity of technology and the high rate of innovation, I think things actually do change more than 20% of the time. So you shouldn't bet your life on the fact that the world doesn't change. But you also shouldn't bet your life on your ability to predict the change, and especially the timing.

PS: It was John Templeton who also said, "The most dangerous words in investment are 'it's different this time.'"

HM: Exactly, so I think you have to balance the two. Things like the psychological or behavioral themes I've mentioned – and by the way, this goes for the various biases, including confirmation bias – I think these things do repeat from year to year, decade to decade, cycle to cycle, however you want to define it. But there's also change, and a lot of that takes place in the mechanical world: changes in information processing, changes in technological products, and so forth.

PS: I'd like to talk more about the memo Investing Without People*. You basically express your worry about mechanical investing, specifically passive investing. I'll quote as follows: "When everyone decides to refrain from performing the functions of analysis, price discovery and asset allocation, the appropriateness of market prices can go out the window as a result of passive investing, just as it does from a mindless boom or bust." Do you think mechanical investing could have a negative impact on informational efficiency because it only uses market internals like market cap, bid/ask, momentum, and, in a way, therefore distorts or ignores the transmission of information coming from the real economy? And, as a consequence, if we look at a chain of discovery through the economic system – starting with a scientist having an insight, and then an inventor having an invention, and an entrepreneur making an innovation, eventually ending up in financial markets valuing this stuff – when things become more and more mechanical through the growth of these strategies – which include high frequency trading, trend-following, smart beta, which you mentioned, and of course passive investing – we run the risk that the separation between Mr. Market and the real economy just increases … that, in other words, this chain becomes more vulnerable and can break?*

HM: You know, Patrick, I think the flaw in passive investing lies in the fact that you have to view passive investing – things like indexation, especially – as kind of a hitchhiker, a free-rider on the market. In other words, there are 1,000 people out here doing active investing and distilling all the information and thinking about the future of the company and thinking about the fairness of the price, and the result is a market price. And, as I said before, that price is the best everybody collectively can do in trying to value the company and its future. And then there are ten people over there who run index funds, and they just buy at the market prices because they think those prices are probably fair, or the best you can do, so why go to all the trouble and expense of doing fundamental analysis? [The managers of passive funds feel no need to independently think about company fundamentals or the fairness of price. They take the active investors' word for it.] So, that's why I say, "free-rider." The ten free-ride on the efforts of the 1,000.

But what happens if the number of people doing fundamental analysis – active investing – declines from 1,000 to 500 to 100 to 50 to 10? Now you have 1,000 people free-riding on the efforts of the ten. The potential for divergence between price and fair price increases, and free-riding is not as easy to do or as risk-free. I think the irony, as I said in that memo, *Investing Without People*, is that active investing is no good; passive investing works better, but only if people keep doing active investing.

You mentioned conundrums. This is a conundrum: the less people invest actively, the greater scope there is for price to diverge from value. In theory, it becomes easier to find bargains and overpriced securities, and the return from active effort rises. So that's the irony.

And, the other thing is, we have to bear in mind that, let's say everybody at this conference stipulated that over the next ten years, every dollar that went into the stock market would go into the S&P 500, perhaps through index funds or ETFs. Clearly, the prices of the S&P 500 stocks would rise, maybe more than they should, and everything else would languish. Given the fundamental realities, eventually the things outside the index would be so demonstrably cheap relative to the things inside the index that they have to begin to do better, at which point active investing outperforms and maybe a few people at the margin give up on passive. So it's kind of reflexive. I take reflexivity to mean that the actions of the participants change the formula for success, and that's what we could be talking about here.

PS: But if we come back to the chain of discovery, if this growing mechanization has an impact on the transmission and allocation of capital at the core of where people innovate, then that clearly is detrimental for society. To put it controversially, but acknowledging this risk, should passive investing be charged for its free-riding and subsidize the extra costs of active investing?

HM: The only way to do that, of course, would be to keep the prices of assets secret and charge people for admission to that room, but I don't think that's ever going to happen. In the memo *Investing Without People*, there are three sections. The first is passive and index, which is here now in a big way. The second is algorithmic and systematic, which is here in a small way. And the third is AI and machine learning, which is really – for investing – not here yet. We know what's happened with passive investing, because it has outperformed active [and now is employed to manage a substantial portion of equity investments]. There are systematic and algorithmic funds like Renaissance that have done a fabulous job and produced very, very high returns, based primarily on finding exceptions to historical patterns, I think. But then what happens when we get into artificial intelligence and machine learning? The questions I posed in the memo included "Can a computer read five business plans and figure out which of them will be the next Amazon?" and "Can a computer sit down with five CEOs and figure out which will be the next Steve Jobs?" Things like that.

I believe not. I believe computers can't. First of all, I don't think the essence of the business plans or the CEOs can completely be converted into data and input into the computers. And I'm not an expert, but I wouldn't think computers can make those qualitative subjective judgments better than the best people. Now clearly, not every person can do those things either. Most people can't sit down with business plans and find Amazon, for example. A few can. They invested in it. Maybe it was Kleiner Perkins, maybe it was Sequoia, or maybe it was Benchmark. So not all the people can do it, but a few have been able to – we can argue about whether that was luck or skill. But I don't think computers will be able to do it, either. To me, the key conclusion of that memo was that computers can outperform most people, but not the best people. If so, there will still be room in active investing for the best. As my mother used to say, it's the exception that proves the rule.

PS: Howard, once again, thank you very much for sharing your insights with us, and we hope to welcome you in person one day in Panmure House. There are many questions on my list that we haven't touched on. I'd like to ask them perhaps one day, another time, but thank you.

HM: Very good Patrick. Thank you for your good questions and for conducting this discussion, and I hope it's what you wanted for yourself and your colleagues.

June 23, 2022

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Memo to: Oaktree Clients

From: Howard Marks

Re: I Beg to Differ

I've written many times about having joined the investment industry in 1969, when the "Nifty Fifty" stocks were in full flower. My first employer, First National City Bank, as well as many of the other "money-center banks" (the leading investment managers of the day), were enthralled with these companies, with their powerful business models and flawless prospects. Sentiment surrounding their stocks was uniformly positive, and portfolio managers found great safety in numbers. For example, a common refrain at the time was "you can't be fired for buying IBM," the era's quintessential growth company.

I've also written extensively about the fate of these stocks. In 1973-74, the OPEC oil embargo and the resultant recession took the S&P 500 Index down a total of 47%. And many of the Nifty Fifty, for which it had been thought that "no price was too high," did far worse, falling from peak p/e ratios of 60-90 to trough multiples in the single digits. Thus, their devotees lost almost all of their money in the stocks of companies that "everyone knew" were great. This was my first chance to see what can happen to assets that are on what I call "the pedestal of popularity."

In 1978, I was asked to move to the bank's bond department to start funds in convertible bonds and, shortly thereafter, high yield bonds. Now I was investing in securities most fiduciaries considered "uninvestable" and which practically no one knew about, cared about, or deemed desirable . . . and I was making money steadily and safely. **I quickly recognized that my strong performance resulted in large part from precisely that fact: I was investing in securities that practically no one knew about, cared about, or deemed desirable.** This brought home the key money-making lesson of the Efficient Market Hypothesis, which I had been introduced to at the University of Chicago Business School: If you seek superior investment results, you have to invest in things that others haven't flocked to and caused to be fully valued. **In other words, you have to do something different.**

The Essential Difference

In 2006, I wrote a memo called *Dare to Be Great*. It was mostly about having high aspirations, and it included a rant against conformity and investment bureaucracy, as well as an assertion that the route to superior returns by necessity runs through unconventionality. The element of that memo that people still talk to me about is a simple two-by-two matrix:

	Conventional Behavior	Unconventional Behavior
Favorable Outcomes	Average good results	Above average results
Unfavorable Outcomes	Average bad results	Below average results

Here's how I explained the situation:

> Of course, it's not easy and clear-cut, but I think it's the general situation. If your behavior and that of your managers is conventional, you're likely to get conventional results – either good or bad. Only if the behavior is unconventional is your performance likely to be unconventional . . . and only if the judgments are superior is your performance likely to be above average.
>
> The consensus opinion of market participants is baked into market prices. Thus, if investors lack insight that is superior to the average of the people who make up the consensus, they should expect average risk-adjusted performance.

Many years have passed since I wrote that memo, and the investing world has gotten a lot more sophisticated, but the message conveyed by the matrix and the accompanying explanation remains unchanged. Talk about simple – in the memo, I reduced the issue to a single sentence: **"This just in: You can't take the same actions as everyone else and expect to outperform."**

The best way to understand this idea is by thinking through a highly logical and almost mathematical process (greatly simplified, as usual, for illustrative purposes):

- A certain (but unascertainable) number of dollars will be made over any given period by all investors collectively in an individual stock, a given market, or all markets taken together. That amount will be a function of (a) how companies or assets fare in fundamental terms (e.g., how their profits grow or decline) and (b) how people feel about those fundamentals and treat asset prices.
- On average, all investors will do average.
- If you're happy doing average, you can simply invest in a broad swath of the assets in question, buying some of each in proportion to its representation in the relevant universe or index. By engaging in average behavior in this way, you're guaranteed average performance. (Obviously, this is the idea behind index funds.)
- If you want to be above average, you have to depart from consensus behavior. You have to overweight some securities, asset classes, or markets and underweight others. **In other words, you have to do something different.**
- The challenge lies in the fact that (a) market prices are the result of everyone's collective thinking and (b) it's hard for any individual to consistently figure out when the consensus is wrong and an asset is priced too high or too low.
- **Nevertheless, "active investors" place active bets in an effort to be above average.**
    - Investor A decides stocks as a whole are too cheap, and he sells bonds in order to overweight stocks. Investor B thinks stocks are too expensive, so she moves to an underweighting by selling some of her stocks to Investor A and putting the proceeds into bonds.
    - Investor X decides a certain stock is too cheap and overweights it, buying from investor Y, who thinks it's too expensive and therefore wants to underweight it.
- **It's essential to note that in each of the above cases, one investor is right and the other is wrong.** Now go back to the first bullet point above: Since the total dollars earned by all investors collectively are fixed in amount, all active bets, taken together, constitute a zero-sum game (or negative-sum after commissions and other costs). The investor who's right earns an above average return, and by definition the one who's wrong earns a below average return.
- **Thus, every active bet placed in the pursuit of above average returns carries with it the risk of below average returns.** There's no way to make an active bet such that you'll win if it works

but not lose if it doesn't. Financial innovations are often described as offering some version of this impossible bargain, but they invariably fail to live up to the hype.

- **The bottom line of the above is simple: You can't hope to earn above average returns if you don't place active bets, but if your active bets are wrong, your return will be below average.**

Investing strikes me as being very much like golf, where playing conditions and the performance of competitors can change from day to day, as can the placement of the holes. On some days, one approach to the course is appropriate, but on other days, different tactics are called for. To win, you have to either do a better job than others of selecting your approach or executing on it, or both.

The same is true for investors. It's simple: **If you hope to distinguish yourself in terms of performance, you have to depart from the pack. But, having departed, the difference will only be positive if your choice of strategies and tactics is correct and/or you're able to execute better.**

<u>Second-Level Thinking</u>

In 2009, when Columbia Business School Publishing was considering whether to publish my book *The Most Important Thing*, they asked to see a sample chapter. As has often been my experience, I sat down and described a concept I hadn't previously written about or named. That description became the book's first chapter, addressing one of its most important topics: second-level thinking. It's certainly the concept from the book that people ask me about most often.

The idea of second-level thinking builds on what I wrote in *Dare to Be Great*. First, I repeated my view that success in investing means doing better than others. All active investors (and certainly money managers hoping to earn a living) are driven by the pursuit of superior returns.

> But that universality also makes beating the market a difficult task. Millions of people are competing for each dollar of investment gain. Who'll get it? The person who's a step ahead. In some pursuits, getting up to the front of the pack means more schooling, more time in the gym or the library, better nutrition, more perspiration, greater stamina or better equipment. But in investing, where these things count for less, it calls for more perceptive thinking . . . at what I call the second level.

The basic idea behind second-level thinking is easily summarized: **In order to outperform, your thinking has to be different and better.**

> Remember, your goal in investing isn't to earn average returns; you want to do better than average. Thus, your thinking has to be better than that of others – both more powerful and at a higher level. Since other investors may be smart, well informed and highly computerized, you must find an edge they don't have. You must think of something they haven't thought of, see things they miss, or bring insight they don't possess. You have to react differently and behave differently. **In short, being right may be a necessary condition for investment success, but it won't be sufficient. You have to be more right than others . . . which by definition means your thinking has to be different.**

Having made the case, I went on to distinguish second-level thinkers from those who operate at the first level:

> First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first-level thinker needs is an opinion about the future, as in "The outlook for the company is favorable, meaning the stock will go up."
>
> Second-level thinking is deep, complex, and convoluted. The second-level thinker takes a great many things into account:
>
> - What is the range of likely future outcomes?
> - What outcome do I think will occur?
> - What's the probability I'm right?
> - What does the consensus think?
> - How does my expectation differ from the consensus?
> - How does the current price for the asset comport with the consensus view of the future, and with mine?
> - Is the consensus psychology that's incorporated in the price too bullish or bearish?
> - What will happen to the asset's price if the consensus turns out to be right, and what if I'm right?
>
> The difference in workload between first-level and second-level thinking is clearly massive, and the number of people capable of the latter is tiny compared to the number capable of the former.
>
> **First-level thinkers look for simple formulas and easy answers. Second-level thinkers know that success in investing is the antithesis of simple.**

Speaking about difficulty reminds me of an important idea that arose in my discussions with my son Andrew during the pandemic (described in the memo *Something of Value*, published in January 2021). In the memo's extensive discussion of how efficient most markets have become in recent decades, Andrew makes a terrific point: **"Readily available quantitative information with regard to the present cannot be the source of superior performance."** After all, everyone has access to this type of information – with regard to public U.S. securities, that's the whole point of the SEC's Reg FD (for fair disclosure) – and nowadays all investors should know how to manipulate data and run screens.

So, then, how can investors who are intent on outperforming hope to reach their goal? As Andrew and I said on a podcast where we discussed *Something of Value*, they have to go beyond readily available quantitative information with regard to the present. Instead, their superiority has to come from an ability to:

- better understand **the significance of the published numbers**,
- better assess **the qualitative aspects of the company**, and/or
- better divine **the future**.

Obviously, none of these things can be determined with certainty, measured empirically, or processed using surefire formulas. Unlike present-day quantitative information, there's no source you can turn to for easy answers. They all come down to judgment or insight. Second-level thinkers who have better judgment are likely to achieve superior returns, and those who are less insightful are likely to generate inferior performance.

This all leads me back to something Charlie Munger told me around the time *The Most Important Thing* was published: "It's not supposed to be easy. Anyone who finds it easy is stupid." **Anyone who thinks there's a formula for investing that guarantees success (and that they can possess it) clearly doesn't understand the complex, dynamic, and competitive nature of the investing process.** The prize for superior investing can amount to a lot of money. In the highly competitive investment arena, it simply can't be easy to be the one who pockets the extra dollars.

<u>Contrarianism</u>

There's a concept in the investing world that's closely related to being different: contrarianism. "The investment herd" refers to the masses of people (or institutions) that drive security prices one way or the other. It's their actions that take asset prices to bull market highs and sometimes bubbles and, in the other direction, to bear market territory and occasional crashes. At these extremes, which are invariably overdone, it's essential to act in a contrary fashion.

Joining in the swings described above causes people to own or buy assets at high prices and to sell or fail to buy at low prices. For this reason, it can be important to part company with the herd and behave in a way that's contrary to the actions of most others.

Contrarianism received its own chapter in *The Most Important Thing.* Here's how I set forth the logic:

- Markets swing dramatically, from bullish to bearish, and from overpriced to underpriced.
- Their movements are driven by the actions of "the crowd," "the herd," and "most people." Bull markets occur because more people want to buy than sell, or the buyers are more highly motivated than the sellers. The market rises as people switch from being sellers to being buyers, and as buyers become even more motivated and the sellers less so. (If buyers didn't predominate, the market wouldn't be rising.)
- Market extremes represent inflection points. These occur when bullishness or bearishness reaches a maximum. Figuratively speaking, a top occurs when the last person who will become a buyer does so. Since every buyer has joined the bullish herd by the time the top is reached, bullishness can go no further, and the market is as high as it can go. Buying or holding is dangerous.
- Since there's no one left to turn bullish, the market stops going up. And if the next day one person switches from buyer to seller, it will start to go down.
- **So at the extremes, which are created by what "most people" believe, most people are wrong.**
- Therefore, the key to investment success has to lie in doing the opposite: in diverging from the crowd. Those who recognize the errors that others make can profit enormously from contrarianism.

To sum up, if the extreme highs and lows are excessive and the result of the concerted, mistaken actions of most investors, then it's essential to leave the crowd and be a contrarian.

In his 2000 book, *Pioneering Portfolio Management*, David Swensen, the former chief investment officer of Yale University, explained why investing institutions are vulnerable to conformity with current consensus belief and why they should instead embrace contrarianism. (For more on Swensen's approach to investing, see "A Case in Point" below.) He also stressed the importance of building infrastructure that enables contrarianism to be employed successfully:

> Unless institutions maintain contrarian positions through difficult times, the resulting damage imposes severe financial and reputational costs on the institution.
>
> Casually researched, consensus-oriented investment positions provide little prospect for producing superior results in the intensely competitive investment management world.
>
> Unfortunately, overcoming the tendency to follow the crowd, while necessary, proves insufficient to guarantee investment success . . . While courage to take a different path enhances chances for success, investors face likely failure unless a thoughtful set of investment principles undergirds the courage.

Before I leave the subject of contrarianism, I want to make something else very clear. First-level thinkers – to the extent they're interested in the concept of contrarianism – might believe contrarianism means doing the opposite of what most people are doing, so selling when the market rises and buying when it falls. But this overly simplistic definition of contrarianism is unlikely to be of much help to investors. Instead, the understanding of contrarianism itself has to take place at a second level.

In *The Most Important Thing Illuminated*, an annotated edition of my book, four professional investors and academics provided commentary on what I had written. My good friend Joel Greenblatt, an exceptional equity investor, provided a very apt observation regarding knee-jerk contrarianism: ". . . just because no one else will jump in front of a Mack truck barreling down the highway doesn't mean that you should." In other words, the mass of investors aren't wrong all the time, or wrong so dependably that it's <u>always</u> right to do the opposite of what they do. Rather, to be an effective contrarian, you have to figure out:

- what the herd is doing;
- why it's doing it;
- what's wrong, if anything, with what it's doing; and
- what you should do about it.

Like the second-level thought process laid out in bullet points on page four, intelligent contrarianism is deep and complex. It amounts to much more than simply doing the opposite of the crowd. **Nevertheless, good investment decisions made at the best opportunities – at the most overdone market extremes – invariably include an element of contrarian thinking.**

<u>The Decision to Risk Being Wrong</u>

There are only so many topics I find worth writing about, and since I know I'll never know all there is to know about them, I return to some from time to time and add to what I've written previously. Thus, in 2014, I followed up on 2006's *Dare to Be Great* with a memo creatively titled *Dare to Be Great II*. To begin, I repeated my insistence on the importance of being different:

> If your portfolio looks like everyone else's, you may do well, or you may do poorly, *but you can't do different*. And being different is absolutely essential if you want a chance at being superior. . . .

I followed that with a discussion of the challenges associated with being different:

> **Most great investments begin in discomfort.** The things most people feel good about – investments where the underlying premise is widely accepted, the recent performance has been positive, and the outlook is rosy – are unlikely to be available at bargain prices. Rather, bargains are usually found among things that are controversial, that people are pessimistic about, and that have been performing badly of late.

But then, perhaps most importantly, I took the idea a step further, moving from daring to be different to its natural corollary: daring to be wrong. Most investment books are about how to be right, not the possibility of being wrong. And yet, the would-be active investor must understand that every attempt at success by necessity carries with it the chance for failure. The two are absolutely inseparable, as I described at the top of page three.

In a market that is even moderately efficient, everything you do to depart from the consensus in pursuit of above average returns has the potential to result in below average returns if your departure turns out to be a mistake. Overweighting something versus underweighting it; concentrating versus diversifying; holding versus selling; hedging versus not hedging – these are all double-edged swords. You gain when you make the right choice and lose when you're wrong.

One of my favorite sayings came from a pit boss at a Las Vegas casino: "The more you bet, the more you win when you win." Absolutely inarguable. But the pit boss conveniently omitted the converse: "The more you bet, the more you lose when you lose." Clearly, those two ideas go together.

In a presentation I occasionally make to institutional clients, I employ PowerPoint animation to graphically portray the essence of this situation:

- A bubble drops down, containing the words "Try to be right." That's what active investing is all about. But then a few more words show up in the bubble: "Run the risk of being wrong." The bottom line is that you simply can't do the former without also doing the latter. They're inextricably intertwined.
- Then another bubble drops down, with the label "Can't lose." There are can't-lose strategies in investing. If you buy T-bills, you can't have a negative return. If you invest in an index fund, you can't underperform the index. But then two more words appear in the second bubble: "Can't win." People who use can't-lose strategies by necessity surrender the possibility of winning. T-bill investors can't earn more than the lowest of yields. Index fund investors can't outperform.
- And that brings me to the assignment I imagine receiving from unenlightened clients: "Just apply the first set of words from each bubble: Try to outperform while employing can't-lose strategies." But that combination happens to be unavailable.

The above shows that active investing carries a cost that goes beyond commissions and management fees: heightened risk of inferior performance. **Thus, every investor has to make a conscious decision about which course to follow. Pursue superior returns at the risk of coming in behind the pack, or hug the consensus position and ensure average performance.** It should be clear that you can't hope to earn superior returns if you're unwilling to bear the risk of sub-par results.

And that brings me to my favorite fortune cookie, which I received with dessert 40-50 years ago. The message inside was simple: **The cautious seldom err or write great poetry**. In my college classes in Japanese studies, I learned about the *koan*, which *Oxford Languages* defines as "a paradoxical anecdote or riddle, used in Zen Buddhism to demonstrate the inadequacy of logical reasoning and to provoke enlightenment." I think of my fortune that way because it raises a question I find paradoxical and capable of leading to enlightenment.

But what does the fortune mean? That you should be cautious, because cautious people seldom make mistakes? Or that you shouldn't be cautious, because cautious people rarely accomplish great things?

The fortune can be read both ways, and both conclusions seem reasonable. Thus the key question is, "Which meaning is right for you?" As an investor, do you like the idea of avoiding error, or would you rather try for superiority? Which path is more likely to lead to success as you define it, and which is more feasible for you? You can follow either path, but clearly not both simultaneously.

Thus, investors have to answer what should be a very basic question: Will you (a) strive to be above average, which costs money, is far from sure to work, and can result in your being below average, or (b) accept average performance – which helps you reduce those costs but also means you'll have to look on with envy as winners report mouth-watering successes. Here's how I put it in *Dare to Be Great II*:

> How much emphasis should be put on diversifying, avoiding risk, and ensuring against below-pack performance, and how much on sacrificing these things in the hope of doing better?

And here's how I described some of the considerations:

> **Unconventional behavior is the only road to superior investment results, but it isn't for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes.** Thus each person has to assess whether he's temperamentally equipped to do these things and whether his circumstances – in terms of employers, clients and the impact of other people's opinions – will allow it . . . when the chips are down and the early going makes him look wrong, as it invariably will.

You can't have it both ways. And as in so many aspects of investing, there's no right or wrong, only right or wrong for you.

A Case in Point

The aforementioned David Swensen ran Yale University's endowment from 1985 until his passing in 2021, an unusual 36-year tenure. He was a true pioneer, developing what has come to be called "the Yale Model" or "the Endowment Model." He radically reduced Yale's holdings of public stocks and bonds, and invested heavily in innovative, illiquid strategies such as hedge funds, venture capital, and private equity at a time when almost no other institutions were doing so. He identified managers in those fields who went on to generate superior results, several of whom earned investment fame. Yale's resulting performance beat almost all other endowments by miles. In addition, Swensen sent out into the endowment community a number of disciples who produced enviable performance for other institutions. Many endowments emulated Yale's approach, especially beginning around 2003-04, after these institutions had been punished by the bursting of the tech/Internet bubble. But few if any duplicated Yale's success. They did the same things, but not nearly as early or as well.

To sum up all the above, I'd say Swensen dared to be different. He did things others didn't do. He did these things long before most others picked up the thread. He did them to a degree that others didn't approach. And he did them with exceptional skill. **What a great formula for outperformance.**

In *Pioneering Portfolio Management*, Swensen provided a description of the challenge at the core of investing – especially institutional investing. It's one of the best paragraphs I've ever read and includes a two-word phrase (which I've bolded for emphasis) that for me reads like sheer investment poetry. I've borrowed it countless times:

> . . . Active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel. Establishing and maintaining an unconventional investment profile requires acceptance of **uncomfortably idiosyncratic** portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.

As with many great quotes, this one from Swensen says a great deal in just a few words. Let's parse its meaning:

Idiosyncratic – When all investors love something, it's likely their buying will render it highly priced. When they hate it, their selling will probably cause it to become cheap. Thus, it's preferable to buy things most people hate and sell things most people love. Such behavior is by definition highly idiosyncratic (i.e., "eccentric," "quirky," or "peculiar").

Uncomfortable – The mass of investors take the positions they take for reasons they find convincing. We witness the same developments they do and are impacted by the same news. Yet, we realize that if we want to be above average, our reaction to those inputs – and thus our behavior – should in many instances be different from that of others. Regardless of the reasons, if millions of investors are doing A, it may be quite uncomfortable to do B.

And if we do bring ourselves to do B, our action is unlikely to prove correct right away. After we've sold a market darling because we think it's overvalued, its price probably won't start to drop the next day. Most of the time, the hot asset you've sold will keep rising for a while, and sometimes a good while. As John Maynard Keynes said, "Markets can remain irrational longer than you can remain solvent." And as the old adage goes, "Being too far ahead of your time is indistinguishable from being wrong." These two ideas are closely related to another great Keynes quote: "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." Departing from the mainstream can be embarrassing and painful.

Uninstitutional behavior from institutions – We all know what Swensen meant by the word "institutions": bureaucratic, hidebound, conservative, conventional, risk-averse, and ruled by consensus; in short, unlikely mavericks. **In such settings, the cost of being different and wrong can be viewed as highly unacceptable relative to the potential benefit from being different and right.** For the people involved, passing up profitable investments (errors of omission) poses far less risk than making investments that produce losses (errors of commission). Thus, investing entities that behave "institutionally" are, by their nature, highly unlikely to engage in idiosyncratic behavior.

Early in his time at Yale, Swensen chose to:

- minimize holdings of public stocks;
- vastly overweight strategies falling under the heading "alternative investments" (although he started to do so well before that label was created);
- in so doing, commit a substantial portion of Yale's endowment to illiquid investments for which there was no market; and
- hire managers without lengthy track records on the basis of what he perceived to be their investment acumen.

To use his words, these actions probably appeared "downright imprudent in the eyes of conventional wisdom." Swensen's behavior was certainly idiosyncratic and uninstitutional, but he understood that the only way to outperform was to risk being wrong, and he accepted that risk with great results.

One Way to Diverge from the Pack

To conclude, I want to describe a recent occurrence. In mid-June, we held the London edition of Oaktree's biannual conference, which followed on the heels of the Los Angeles version. My assigned topic at both conferences was the market environment. I faced a dilemma while preparing for the London conference, because so much had changed between the two events: On May 19, the S&P 500 was at roughly 3,900, but by June 21 it was at approximately 3,750, down almost 4% in roughly a month. Here was my issue: Should I update my slides, which had become somewhat dated, or reuse the LA slides to deliver a consistent message to both audiences?

I decided to use the LA slides as the jumping-off point for a discussion of how much things had changed in that short period. The key segment of my London presentation consisted of a stream-of-consciousness discussion of the concerns of the day. I told the attendees that I pay close attention to the questions people ask most often at any given point in time, as the questions tell me what's on people's minds. And the questions I'm asked these days overwhelmingly surround:

- the outlook for **inflation**,
- the extent to which the Federal Reserve will raise **interest rates** to bring it under control, and
- whether doing so will produce a soft landing or a **recession** (and if the latter, how bad).

Afterwards, I wasn't completely happy with my remarks, so I rethought them over lunch. And when it was time to resume the program, I went up on stage for another two minutes. Here's what I said:

All the discussion surrounding inflation, rates, and recession falls under the same heading: the short term. And yet:

- We can't know much about the short-term future (or, I should say, we can't dependably know more than the consensus).
- If we have an opinion about the short term, we can't (or shouldn't) have much confidence in it.
- If we reach a conclusion, there's not much we can do about it – most investors can't and won't meaningfully revamp their portfolios based on such opinions.
- **We really shouldn't care about the short term – after all, we're investors, not traders.**

I think it's the last point that matters most. The question is whether you agree or not.

For example, when asked whether we're heading toward a recession, my usual answer is that whenever we're not in a recession, we're heading toward one. The question is when. I believe we'll always have cycles, which means recessions and recoveries will always lie ahead. **Does the fact that there's a recession ahead mean we should reduce our investments or alter our portfolio allocation? I don't think so.** Since 1920, there have been 17 recessions as well as one Great Depression, a World War and several smaller wars, multiple periods of worry about global cataclysm, and now a pandemic. And yet, as I mentioned in my January memo, *Selling Out*, the S&P 500 has returned about 10½% a year on average over that century-plus. Would investors have improved their performance by getting in and out of the market to avoid those problem spots . . . or would doing so have diminished it? Ever since I quoted Bill Miller in that memo, I've been impressed by his formulation that "it's time, not timing" that leads to real wealth accumulation. Thus, most investors would be better off ignoring short-term considerations if they want to enjoy the benefits of long-term compounding.

Two of the six tenets of Oaktree's investment philosophy say (a) we don't base our investment decisions on macro forecasts and (b) we're not market timers. **I told the London audience our main goal is to buy debt or make loans that will be repaid and to buy interests in companies that will do well and make money. None of that has anything to do with the short term.**

From time to time, when we consider it warranted, we do vary our balance between aggressiveness and defensiveness, primarily by altering the size of our closed-end funds, the pace at which we invest, and the level of risk we'll accept. But we do these things on the basis of current market conditions, not expectations regarding future events.

Everyone at Oaktree has opinions on the short-run phenomena mentioned above. We just don't bet heavily that they're right. During our recent meetings with clients in London, Bruce Karsh and I spent a lot of time discussing the significance of the short-term concerns. Here's how he followed up in a note to me:

> . . . Will things be as bad or worse or better than expected? Unknowable . . . and equally unknowable how much is priced in, i.e. what the market is truly expecting. One would think a recession is priced in, but many analysts say that's not the case. This stuff is hard…!!!

Bruce's comment highlights another weakness of having a short-term focus. Even if we think we know what's in store in terms of things like inflation, recessions, and interest rates, there's absolutely no way to know how market prices comport with those expectations. This is more significant than most people realize. If you've developed opinions regarding the issues of the day, or have access to those of pundits you respect, take a look at any asset and ask yourself whether it's priced rich, cheap, or fair in light of those views. That's what matters when you're pursuing investments that are reasonably priced.

The possibility – or even the fact – that a negative event lies ahead isn't in itself a reason to reduce risk; investors should only do so if the event lies ahead <u>and</u> it isn't appropriately reflected in asset prices. But, as Bruce says, there's usually no way to know.

At the beginning of my career, we thought in terms of investing in a stock for five or six years; something held for less than a year was considered a short-term trade. One of the biggest changes I've witnessed since then is the incredible shortening of time horizons. Money managers know their returns in real time, and many clients are fixated on how their managers did in the most recent quarter.

No strategy – and no level of brilliance – will make every quarter or every year a successful one. Strategies become more or less effective as the environment changes and their popularity waxes and wanes. In fact, highly disciplined managers who hold most rigorously to a given approach will tend to report the worst performance when that approach goes out of favor. Regardless of the appropriateness of a strategy and the quality of investment decisions, every portfolio and every manager will experience good and bad quarters and years that have no lasting impact and say nothing about the manager's ability. Often this poor performance will be due to unforeseen and unforeseeable developments.

Thus, what does it mean that someone or something has performed poorly for a while? No one should fire managers or change strategies based on short-term results. Rather than taking capital away from underperformers, clients should consider increasing their allocations in the spirit of contrarianism (but few do). **I find it incredibly simple: If you wait at a bus stop long enough, you're guaranteed to catch a bus, but if you run from bus stop to bus stop, you may never catch a bus.**

I believe most investors have their eye on the wrong ball. One quarter's or one year's performance is meaningless at best and a harmful distraction at worst. But most investment committees still spend the first hour of every meeting discussing returns in the most recent quarter and the year to date. **If everyone else is focusing on something that doesn't matter and ignoring the thing that does, investors can profitably diverge from the pack by blocking out short-term concerns and maintaining a laser focus on long-term capital deployment.**

A final quote from *Pioneering Portfolio Management* does a great job of summing up how institutions can pursue the superior performance most want. (Its concepts are also relevant to individuals):

> Appropriate investment procedures contribute significantly to investment success, allowing investors to pursue profitable long-term contrarian investment positions. By reducing pressures to produce in the short run, liberated managers gain the freedom to create portfolios positioned to take advantage of opportunities created by short-term players. By encouraging managers to make potentially embarrassing out-of-favor investments, fiduciaries increase the likelihood of investment success.

Oaktree is probably in the extreme minority in its relative indifference to macro projections, especially regarding the short term. Most investors fuss over expectations regarding short-term phenomena, but I wonder whether they actually do much about their concerns, and whether it helps.

Many investors – and especially institutions such as pension funds, endowments, insurance companies, and sovereign wealth funds, all of which are relatively insulated from the risk of sudden withdrawals – have the luxury of being able to focus exclusively on the long term . . . if they will take advantage of it. Thus, my suggestion to you is to depart from the investment crowd, with its unhelpful preoccupation with the short term, and to instead join us in focusing on the things that really matter.

July 26, 2022

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Illusion of Knowledge

I've been expressing my disregard for forecasts for almost as long as I've been writing my memos, starting with *The Value of Predictions, or Where'd All This Rain Come From* in February 1993. Over the years since then, I've explained at length why I'm not interested in forecasts – a few of my favorite quotes echoing my disdain head the sections below – but I've never devoted a memo to explaining why making helpful macro forecasts is so difficult. So here it is.

Food for Thought

> There are two kinds of forecasters: those who don't know, and those who don't know they don't know.
>
> – John Kenneth Galbraith

Shortly after putting the finishing touches on *I Beg to Differ* in July, I attended a lunch with a number of experienced investors, plus a few people from outside the investment industry. It wasn't organized as a social occasion but rather an opportunity for those present to exchange views regarding the investment environment.

At one point, the host posed a series of questions: What's your expectation regarding inflation? Will there be a recession, and if so, how bad? How will the war in Ukraine end? What do you think is going to happen in Taiwan? What's likely to be the impact of the 2022 and '24 U.S. elections? I listened as a variety of opinions were expressed.

Regular readers of my memos can imagine what went through my mind: "Not one person in this room is an expert on foreign affairs or politics. No one present has particular knowledge of these topics, and certainly not more than the average intelligent person who read this morning's news." None of the thoughts expressed, even on economic matters, seemed much more persuasive than the others, and I was absolutely convinced that none were capable of improving investment results. And that's the point.

It was that lunch that started me thinking about writing yet another memo on the futility of macro forecasting. Soon thereafter a few additional inputs arrived – a book, a piece in *Bloomberg Opinion*, and a newspaper article – all of which supported my thesis (or perhaps played to my "confirmation bias" – i.e., the tendency to embrace and interpret new information in a manner that confirms one's preexisting views). Together, the lunch and these items inspired this memo's theme: **the reasons why forecasts are rarely helpful**.

In order to produce something useful – be it in manufacturing, academia, or even the arts – you must have a reliable **process** capable of converting the required **inputs** into the desired **output**. The problem, in short, is that I don't think there can be a process capable of consistently turning the large number of variables associated with economies and financial markets (the inputs) into a useful macro forecast (the output).

The Machine

> The greatest enemy of knowledge is not ignorance, it is the illusion of knowledge.
>
> – Daniel J. Boorstin

In my first decade or so working at First National City Bank, a word was in vogue that I haven't heard in a long time: econometrics. This is the practice of looking for relationships within economic data that can lead to valid forecasts. Or, to simplify, I'd say econometrics is concerned with building a mathematical model of an economy. Econometricians were heard from a great deal in the 1970s, but I don't believe they are any longer. I take that to mean their models didn't work.

Forecasters have no choice but to base their judgments on models, be they complex or informal, mathematical or intuitive. Models, by definition, consist of assumptions: "If A happens, then B will happen." In other words, relationships and responses. But for us to willingly employ a model's output, we have to believe the model is reliable. When I think about modeling an economy, my first reaction is to think about how incredibly complicated it is.

The U.S., for example, has a population of around 330 million. All but the very youngest and perhaps the very oldest are participants in the economy. Thus, there are hundreds of millions of consumers, plus millions of workers, producers, and intermediaries (many people fall into more than one category). To predict the path of the economy, you have to forecast the behavior of these people – if not for every participant, then at least for group aggregates.

A real simulation of the U.S. economy would have to deal with billions of interactions or nodes, including interactions with suppliers, customers, and other market participants around the globe. Is it possible to do this? Is it possible, for example, to predict how consumers will behave (a) if they receive an additional dollar of income (what will be the "marginal propensity to consume"?); (b) if energy prices rise, squeezing other household budget categories; (c) if the price for one good rises relative to others (will there be a "substitution effect"?); or (d) if the geopolitical arena is roiled by events continents away?

Clearly, this level of complexity necessitates the frequent use of simplifying assumptions. For example, it would make modeling easier to be able to assume that consumers won't buy B in place of A if B isn't either better or cheaper (or both). And it would help to assume that producers won't price X below Y if it doesn't cost less to produce X than Y. But what if consumers are attracted to the prestige of B despite (or even because of) its higher price? And what if X has been developed by an entrepreneur who's willing to lose money for a few years to gain market share? Is it possible for a model to anticipate the consumer's decision to pay up and the entrepreneur's decision to make less (or even lose) money?

Further, a model will have to predict how each group of participants in the economy will behave in a variety of environments. But the vagaries are manifold. For example, consumers may behave one way at one moment and a different way at another similar moment. Given the large number of variables involved, it seems impossible that two "similar" moments will play out exactly the same way, and thus that we'll witness the same behavior on the part of participants in the economy. Among other things, participants' behavior will be influenced by their psychology (or should I say their emotions?), and their psychology can be affected by qualitative, non-economic developments. How can those be modeled?

How can a model of an economy be comprehensive enough to deal with things that haven't been seen before, or haven't been seen in modern times (meaning under comparable circumstances)? This is yet another example of why a model simply can't replicate something as complex as an economy.

Of course, a prime example of this is the Covid-19 pandemic. It caused much of the world's economy to be shut down, turned consumer behavior on its head, and inspired massive government largesse. What aspect of a pre-existing model would have enabled it to anticipate the pandemic's impact? Yes, we had a pandemic in 1918, but the circumstances were so different (no iPhones, Zoom calls, etc. ad infinitum) as to render economic events during that time of little or no relevance to 2020.

In addition to the matter of complexity and the difficulty of capturing psychological fluctuations and dynamic processes, think about the limitations that bear on an attempt to predict something that can't be expected to remain unchanged. Shortly after starting on this memo, I received my regular weekly edition of Morgan Housel's always-brilliant newsletter. One of the articles described a number of observations from other arenas that have relevance to our world of economics and investing. Here are two, borrowed from the field of statistics, that I think are pertinent to the discussion of economic models and forecasts ("Little Ways the World Works," Morgan Housel, *Collaborative Fund*, July 20, 2022):

> Stationarity: An assumption that the past is a statistical guide to the future, based on the idea that the big forces that impact a system don't change over time. If you want to know how tall to build a levee, look at the last 100 years of flood data and assume the next 100 years will be the same. Stationarity is a wonderful, science-based concept that works right up until the moment it doesn't. It's a major driver of what matters in economics and politics. [But in our world,] "Things that have never happened before happen all the time," says Stanford professor Scott Sagan.
>
> Cromwell's rule: Never say something cannot occur . . . . If something has a one-in-a-billion chance of being true, and you interact with billions of things during your lifetime, you are nearly assured to experience some astounding surprises, and should always leave open the possibility of the unthinkable coming true.

Stationarity might be fairly assumed in the realm of the physical sciences. For example, thanks to the law of universal gravitation, under given atmospheric conditions, the speed at which an object falls can always be counted on to accelerate at the same rate. It always has, and it always will. But few processes can be counted on to be stationary in our world, especially given the role played by psychology, emotion, and human behavior, and their propensity to vary over time.

Take, for example, the relationship between unemployment and inflation. For roughly the last 60 years, economists relied on the Phillips curve, which holds that wage inflation will rise as the unemployment rate declines, because when there are fewer idle workers on the sidelines, employees gain bargaining power and can successfully negotiate for higher wages. It was also believed for decades that an unemployment rate around 5.5% indicated "full employment." But unemployment fell below 5.5% in March 2015 (and reached a 50-year low of 3.5% in September 2019), yet there was no significant increase in inflation (in wages or otherwise) until 2021. So the Phillips curve described an important relationship that was built into economic models for decades but, seemingly, didn't apply over much of the last decade.

Cromwell's rule is also relevant. Unlike in the physical sciences, in markets and economies there's very little that absolutely has to happen or definitely can't happen. Thus, in my book *Mastering the Market Cycle*, I listed seven terms that investors should purge from their vocabularies: "never," "always," "forever," "can't," "won't," "will," and "has to." But if it's true that those words have to be discarded, then so too must the idea that one can build a model that can dependably predict the macro future. In other words, very little is immutable in our world.

The unpredictability of behavior is a favorite topic of mine. Noted physicist Richard Feynman once said, "Imagine how much harder physics would be if electrons had feelings." The rules of physics are reliable precisely because electrons always do what they're supposed to do. They never forget to perform. They never rebel. They never go on strike. They never innovate. They never behave in a contrary manner. **But none of these things is true of the participants in an economy, and for that reason their behavior is unpredictable. And if the participants' behavior is unpredictable, how can the workings of an economy be modeled?**

What we're talking about here is the future, and there's simply no way to deal with the future that doesn't require the making of assumptions. Small errors in assumptions regarding the economic environment and small changes in participants' behavior can make differences that are highly problematic. As mathematician and meteorologist Edward Lorenz famously suggested, "The flapping of a butterfly's wings in Brazil could set off a tornado in Texas." (Historian Niall Ferguson references this remark in the article I discuss below.)

Thinking about all the above, can we ever consider a model of an economy to be reliable? Can a model replicate reality? Can it describe the millions of participants and their interactions? Are the processes it attempts to model dependable? Can the processes be reduced to mathematics? Can mathematics capture the qualitative nuances of people and their behavior? Can a model anticipate changes in consumer preferences, changes in the behavior of businesses, and participants' reactions to innovation? In other words, can we trust its output?

Clearly, economic relationships aren't hard-wired, and economies aren't governed by schematic diagrams (which models try to simulate). **Thus, for me, the bottom line is that the output from a model may point in the right direction much of the time, when the assumptions aren't violated. But it can't always be accurate, especially at critical moments such as inflection points . . . and that's when accurate predictions would be most valuable.**

<u>The Inputs</u>

> No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future.
>
> – Ian H. Wilson (former GE executive)

Having considered the incredible complexity of an economy and the need to make simplifying assumptions that decrease any economic model's accuracy, let's now think about the inputs a model requires – the raw materials from which forecasts are manufactured. Will the estimated inputs prove valid? Can we know enough about them for the resulting forecast to be meaningful? **Or will we simply be reminded of the ultimate truth about models: "garbage in, garbage out"?** Clearly, no forecast can be better than the inputs on which it's based.

Here's what Niall Ferguson wrote in *Bloomberg Opinion* on July 17:

> Consider for a moment what we are implicitly asking when we pose the question: Has inflation peaked? We are not only asking about the supply of and demand for 94,000 different commodities, manufactures and services. We are also asking about the future path of interest rates set by the Fed, which – despite the much-vaunted policy of "forward guidance" – is far from certain. We are asking about how long the strength of the dollar will be sustained, as it is currently holding down the price of U.S. imports.

> But there's more. We are at the same time implicitly asking how long the war in Ukraine will last, as the disruption caused since February by the Russian invasion has significantly exacerbated energy and food price inflation. We are asking whether oil-producing countries such as Saudi Arabia will respond to pleas from Western governments to pump more crude. . . .
>
> We should probably also ask ourselves what the impact on Western labor markets will be of the latest Covid omicron sub-variant, BA.5. UK data indicate that BA.5 is 35% more transmissible than its predecessor BA.2, which in turn was over 20% more transmissible than the original omicron.
>
> Good luck adding all those variables to your model. It is in fact just as impossible to be sure about the future path of inflation as it is to be sure about the future path of the war in Ukraine and the future path of the Covid pandemic.

I found Ferguson's article so relevant to the subject of this memo that I'm including a link to it here. It makes a lot of important points, although I beg to differ in one regard. Ferguson says above, "It is in fact just as impossible to be sure about the future path of inflation as it is to be sure about the future path of the war in Ukraine and the future path of the Covid pandemic." I think accurately predicting inflation is "more impossible" (if there is such a thing) than predicting the outcomes of the other two, since doing so requires being right about both of those outcomes and a thousand other things. How can anyone possibly get all these things right?

Here's my rough description of the forecasting process from *The Value of Predictions*:

> I imagine that for most money managers, the process goes like this: "I predict the economy will do A. If A happens, interest rates should do B. With interest rates of B, the stock market should do C. Under that environment, the best performing sector should be D, and stock E should rise the most." The portfolio expected to do best under that scenario is then assembled.
>
> But how likely is E anyway? Remember that E is conditioned on A, B, C and D. Being right two-thirds of the time would be a great accomplishment in the world of forecasting. But if each of the five predictions has a 67% chance of being right, then there is a 13% probability that all five will be correct and that the stock will perform as expected.

Predicting event E on the basis of assumptions concerning A, B, C and D is what I call single-scenario forecasting. In other words, if what was assumed regarding A, B, C or D turns out to have been erroneous, the forecasted outcome for E is unlikely to materialize. All of the underlying forecasts have to be right in order for E to turn out as predicted, and that's highly improbable. No one can invest intelligently without considering (a) the other possible outcomes for each element, (b) the likelihood of these alternative scenarios, (c) what would have to happen for one of them to be the actual outcome, and (d) what the impact on E would be.

Ferguson's article raises an interesting question about economic modeling: What's to be assumed regarding the general macro environment under which economic participants will operate? **Doesn't this question indicate an insoluble feedback loop: To predict the overall performance of the economy, we need to make assumptions about, for example, consumer behavior. But to predict consumer behavior, don't we need to make assumptions regarding the overall economic environment?**
In *Nobody Knows II* (March 2020), my first memo of the pandemic, I mentioned that in a discussion of the coronavirus, Harvard epidemiologist Marc Lipsitch had said there are (a) facts, (b) informed

extrapolations from analogies to other viruses, and (c) opinion or speculation. This is standard fare when we deal with uncertain events. In the case of economic or market forecasts, we have a vast trove of history and lots of analogous past events from which to extrapolate (neither of which was the case with Covid-19). But even when these things are used as inputs for a well-constructed forecasting machine, they're still highly unlikely to be predictive of the future. They may be useful fodder, or they may be garbage.

To illustrate, people often ask me which of the past cycles I've experienced was most like this one. My answer is that current developments bear a passing resemblance to some past cycles, but there is no absolute parallel. **The differences are profound in every case and outweigh the similarities. And even if we could find an <u>identical</u> prior period, how much reliance should we put on a sample size of one? I'd say not much. Investors rely on historical references (and the forecasts they foster) because they fear that without them they'd be flying blind. But that doesn't make them reliable.**

<u>Unpredictable Influences</u>

> Forecasts create the mirage that the future is knowable.
>
> – Peter Bernstein

We can't consider the reasonableness of forecasting without first deciding whether we think our world is one of order or of randomness. Put simply, is it entirely predictable, entirely unpredictable, or something in between? The bottom line for me is that it's in between, but unpredictable enough that most forecasts are unhelpful. And since our world is predictable at some times and unpredictable at others, what good are forecasts if we can't tell which is which?

I learned a new word from reading Ferguson's article: "deterministic." It's defined by *Oxford Languages* as "causally determined by preceding events or natural laws." The world is much simpler when we deal with things that function according to rules . . . like Feynman's electrons. But, clearly, economies and markets aren't governed by natural laws – thanks to the involvement of people – and preceding events may "set the stage" or "tend to repeat," but events rarely unfold in the same way twice. Thus, I believe the processes that constitute the operation of economies and markets aren't deterministic, meaning they aren't predictable.

Further, the inputs clearly are undependable. Many are subject to randomness, such as weather, earthquakes, accidents, and deaths. Others involve political and geopolitical issues – ones we're aware of and ones that haven't yet surfaced.

In his *Bloomberg Opinion* article, Ferguson mentioned the English writer G. K. Chesterton. That reminded me to include a Chesterton quote that I used in *Risk Revisited Again* (June 2015):

> The real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable, but not quite. Life is not an illogicality; yet it is a trap for logicians. **It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait.** (Emphasis added)

Going back to the lunch described on page one, the host opened the proceedings roughly as follows: "In recent years, we've experienced the Covid-19 pandemic, the surprising success of the Fed's rescue actions, and the invasion of Ukraine. This has been a very challenging environment, since all of these developments arrived out of the blue." I imagine the implication for him was that the attendees should let themselves off the hook for the inaccuracy of their 2020-22 forecasts and go back to work predicting future events and betting on their judgments. But my reaction was quite different: "The list of events that shaped the current environment is quite extensive. **Doesn't the fact that no one was able to predict any of them convince those present that they should give up on forecasting?"**

For another example, let's think back to the fall of 2016. There were two things that almost everyone was sure of: (a) Hillary Clinton would be elected president and (b) if for some reason Donald Trump were elected instead, the markets would tank. Nonetheless, Trump won, and the markets soared. The impact on the economy and markets over the last six years was profound, and **I'm confident no forecast that took a conventional view of the coming 2016 election got the period since then correct.** Again, shouldn't that be enough to convince people that (a) we don't know what's going to happen and (b) we don't know how the markets will react to what happens?

Do Forecasts Add Value?

> 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.
>
> – Mark Twain

As I mentioned in my recent memo *Thinking About Macro*, in the 1970s we used to describe an economist as "a portfolio manager who never marks to market." In other words, economists make forecasts; events prove them either wrong or right; they go on to make new forecasts; but they don't keep track of how often they get it right (or they don't publish the stats).

Can you imagine hiring a money manager (or being hired, if you are a money manager) without reference to a track record? And yet, economists and strategists stay in business, presumably because there are customers for their forecasts, despite there being no published records.

Are you a consumer of forecasts? Are there forecasters and economists on staff where you work? Or do you subscribe to their publications and invite them in for briefings, as was the case with my previous employers? If so, do you know how often each has been right? Have you found a way to rigorously determine which ones to rely on and which to ignore? Is there a way to quantify their contributions to your investment returns? I ask because I've never seen or heard of any research along these lines. The world seems incredibly short on information regarding the value added by macro forecasts, especially given the large number of people involved in this pursuit.

Despite the lack of evidence regarding its value, macro forecasting goes on. Many of the forecasters are part of teams managing equity funds, or they provide advice and forecasts to those teams. What we know for sure is that actively managed equity funds have been losing market share to index funds and other passive vehicles for decades due to the poor performance of active management, and as a result, actively managed funds now account for less than half of the capital in U.S. equity mutual funds. Could the unhelpful nature of macro forecasts be part of the reason?

The only place I know to look for quantification regarding this issue is the performance of so-called macro hedge funds. Hedge Fund Research (HFR) publishes broad hedge fund performance indices as well as a number of sub-indices. Below is the long-term performance of a broad hedge fund index, a macro fund sub-index, and the Standard & Poor's 500 Index.

	HFRI Hedge Fund Index*	HFRI Macro (Total) Index	S&P 500 Index
5-year annualized return*	5.2%	5.0%	12.8%
10-year annualized return*	5.1	2.8	13.8

* Performance through July 31, 2022. The broad hedge fund index shown is the Fund Weighted Composite Index.

What the table above shows is that, according to HFR, the average hedge fund woefully underperformed the S&P 500 in the period under study, and the average macro fund did considerably worse (especially in the period from 2012 to 2017). Given that investors continue to entrust roughly $4.5 trillion of capital to hedge funds, they must deliver some benefit other than returns, but it's not obvious what that could be. This seems to be especially true for the macro funds.

To support my opinion regarding forecasts, I'll cite a rare example of self-assessment: a seven-page feature that appeared in the Sunday Opinion section of *The New York Times* on July 24 titled "I Was Wrong." In it, eight *Times* opinion writers opened up about incorrect predictions they made and flawed advice they had given. The most relevant here is Paul Krugman, who wrote a confession titled "I Was Wrong About Inflation." I'll string together some excerpts:

> In early 2021, there was an intense debate among economists about the likely consequences of the American Rescue Plan . . . . I was on [the side that was less concerned about the impact on inflation]. As it turned out, of course, that was a very bad call. . . .
>
> . . . history wouldn't have led us to expect this much inflation from overheating. So **something was wrong with my model** . . . . One possibility is that **history was misleading** . . . . Also, disruptions associated with adjusting to the pandemic and its aftermath may still be playing a large role. And of course both Russia's invasion of Ukraine and China's lockdown of major cities have added **a whole new level of disruption. . . .**
>
> In any case, the whole experience has been **a lesson in humility**. Nobody will believe this, but in the aftermath of the 2008 crisis, standard economic models performed pretty well, and I felt comfortable applying these models in 2021. But in retrospect I should have realized that in the face of the new world created by Covid-19, that kind of **extrapolation wasn't a safe bet**. (Emphasis added)

I salute Krugman for this incredible bout of candor (although I have to say I don't remember a lot of 2009-10 market forecasts that were optimistic enough to capture the reality of the subsequent decade). **Krugman's explanation for his error is fine as far as it goes, but I don't see any mention of abstaining from modeling, extrapolating, or forecasting in the future.**

Humility may even be seeping into one of the world's biggest producers of economic forecasts, the U.S. Federal Reserve, home of more than 400 Ph.D. economists. Here's what economist Gary Shilling wrote in *Bloomberg Opinion* on August 22:

> The Federal Reserve's forward guidance program has been a disaster, so much so that it has strained the central bank's credibility. Chair Jerome Powell seems to agree that

> providing estimates of where the Fed sees interest rates, economic growth and inflation at different points in the future should be junked. . . .
>
> **The basic problem with forward guidance is that it depends on data that the Fed had a miserable record of forecasting.** It was consistently too optimistic about an economic recovery after the 2007-2009 Great Recession. In September 2014, policy makers forecast real gross domestic product growth in 2015 of 3.40% but were forced to constantly crank their expectations down to 2.10% by September 2015.
>
> **The federal funds rate is not a market-determined interest rate but is set and controlled by the Fed, and nobody challenges the central bank. Yet the FOMC members were infamously terrible at forecasting what they themselves would do** . . . In 2015, their average projection of the 2016 federal funds rate was 0.90% and 3.30% in 2019. The actual numbers were 0.38% and 2.38%. . . .
>
> To be sure, many current events today have caused uncertainty in markets, but the Fed has been in there hot and heavy with its forward guidance. Recall that early this year the central bank believed that inflation caused by frictions in reopening the economy after the pandemic and supply-chain disruptions was temporary. Only belatedly did it reverse gears, raise rates and signal that further substantial hikes are coming. Faulty Fed forecasts resulted in faulty forward guidance and increased financial market volatility. (Emphasis added)

Lastly on this subject, where are the people who've gotten famous (and rich) by profiting from macro views? I certainly don't know everyone in the investment world, but among the people I do know or am aware of, there are only a few highly successful "macro investors." When the number of instances of something is tiny, it's an indication, as my mother used to say, that they're "the exceptions that prove the rule." **The rule in this case is that macro forecasts rarely lead to exceptional performance. For me, the exceptionalness of the success stories proves the general truth of that assertion.**

<u>Practitioners' Need to Predict</u>

> Forecasts usually tell us more of the forecaster than of the future.
>
> – Warren Buffett

How many people are capable of making macro forecasts that are valuable most of the time? Not many, I think. And how many investment managers, economists, and forecasters try? Thousands, at a minimum. That raises an interesting question: why? If macro forecasts don't add to investment success over time, why do so many members of the investment management industry espouse belief in forecasts and pursue them? I think the reasons probably center on these:

- It's part of the job.
- Investors have always done it.
- Everyone I know does it, especially my competitors.
- I've always done it – I can't quit now.
- If I don't do it, I won't be able to attract clients.

- Since investing consists of positioning capital to benefit from future events, how can anyone expect to do a good job without a view regarding what those events will be? We need forecasts, even if they're imperfect.

This summer, at the suggestion of my son Andrew, I read an extremely interesting book: *Mistakes Were Made (but Not by Me): Why We Justify Foolish Beliefs, Bad Decisions, and Hurtful Acts*, written by psychologists Carol Tavris and Elliot Aronson. **Its topic is self-justification. The authors explain that "cognitive dissonance" arises when people are confronted with new evidence that calls into question their pre-existing positions and that when it does, unconscious mechanisms enable them to justify and uphold those positions.** Here are some selected quotes:

> If you hold a set of beliefs that guide your practice and you learn that some of them are incorrect, you must either admit you were wrong and change your approach or reject the new evidence.
>
> Most people, when directly confronted by evidence that they are wrong, do not change their point of view or plan of action but justify it even more tenaciously.
>
> Once we are invested in a belief and have justified its wisdom, changing our minds is literally hard work. It's much easier to slot that new evidence into an existing framework and do the mental justification to keep it there than it is to change the framework.

The mechanisms that people generally employ when responding to evidence that throws their beliefs into doubt include these (paraphrasing the authors' words):

- an unwillingness to heed dissonant information;
- selectively remembering parts of their lives, focusing on those parts that support their own points of view; and
- operating under cognitive biases that ensure people see what they want to see and seek confirmation of what they already believe.

I have little doubt that these are among the factors that cause and enable people to continue making and consuming forecasts. What specific form might they take in this case?

- thinking of macro forecasts as an indispensable part of investing;
- pleasantly recalling correct forecasts, especially any that were bold and non-consensus;
- overestimating how often forecasts were right;
- forgetting or minimizing the ones that were wrong;
- not keeping records regarding forecasts' accuracy or failing to calculate a batting average;
- focusing on the "pot of gold" that will reward correct forecasts in the future;
- saying "everyone does it"; and
- perhaps most importantly, blaming unsuccessful forecasts on having been blindsided by random occurrences or exogenous events. (But, as I said earlier, that's the point: Why make forecasts if they're so easily rendered inaccurate?)

Most people – even honest people with good intentions – take positions or actions that are in their own interests, sometimes at the expense of others or of objective truth. They don't know they're doing it; they think it's the right thing; and they have tons of justification. As Charlie Munger often says, quoting Demosthenes, "Nothing is easier than self-deceit. For what every man wishes, that he also believes to be true."

I don't think of forecasters as crooks or charlatans. Most are bright, educated people who think they're doing something useful. **But self-interest causes them to act in a certain way, and self-justification enables them to stick with it in the face of evidence to the contrary.** As Morgan Housel put it in a recent newsletter:

> The inability to forecast the past has no impact on our desire to forecast the future. Certainty is so valuable that we'll never give up the quest for it, and most people couldn't get out of bed in the morning if they were honest about how uncertain the future is. ("Big Beliefs," *Collaborative Fund*, August 24, 2022)

For my birthday several years ago, my Oaktree co-founder Richard Masson gave me one of his typical quirky gifts. In this case, it consisted of some bound copies of *The New York Times*. I've been waiting for an opportunity to write about my favorite sub-headline from the issue dated October 30, 1929, which followed two days on which the Dow Jones Industrial Average declined by a total of 23%. **It read, "Bankers Optimistic."** (Less than three years later, the Dow was roughly 85% lower.) Most bankers – and most money managers – seem to be congenitally optimistic about the future. Among other things, it's in their best interests, as it helps them do more business. But their optimism certainly shapes their forecasts and their resulting behavior.

Can They or Can't They?

> I never think about the future – it comes soon enough.
>
> – Albert Einstein

Consider the following aspects of macro forecasting:

- the number of assumptions/inputs that are required,
- the number of processes/relationships that have to be incorporated,
- the inherent undependability and instability of those processes, and
- the role of randomness and the likelihood of surprises.

The bottom line for me is that forecasts can't be right often enough to be worthwhile. I've described it many times, but just for the sake of completeness, I'm going to restate my view of the utility (or rather, futility) of macro forecasts:

- Most forecasts consist of extrapolation of past performance.
- Because macro developments usually don't diverge from prior trends, extrapolation is usually successful.
- Thus, most forecasts are correct. But since extrapolation is usually anticipated by security prices, those who follow expectations based on extrapolation don't enjoy unusual profits when it holds.
- Once in a while, the behavior of the economy does deviate materially from past patterns. Since this deviation comes as a surprise to most investors, its occurrence moves markets, meaning an accurate prediction of the deviation would be highly profitable.
- However, since the economy doesn't diverge from past performance very often, correct forecasts of deviation are rarely made and most forecasts of deviation turn out to be incorrect.

- Thus, we have (a) extrapolation forecasts, most of which are correct but unprofitable, and (b) potentially profitable forecasts of deviation, which are rarely correct and thus are generally unprofitable.
- Q.E.D.: Most forecasts don't add to returns.

At the lunch described at the beginning of this memo, people were asked what they expected in terms of, for example, Fed policy, and how that influenced their investment stance. One person replied with something like, "I think the Fed will remain very worried about inflation and thus will raise rates significantly, bringing on a recession. So I'm in risk-off mode." Another said, "I foresee inflation moderating in the fourth quarter, allowing the Fed to turn dovish in January. That will allow them to bring interest rates back down and stimulate the economy. I'm very bullish on 2023."

We hear statements like these all the time. **But it must be recognized that these people are applying one-factor models:** The speaker is basing his or her forecast on a single variable. Talk about simplifying assumptions: These forecasters are implicitly holding everything constant other than Fed policy. They're playing checkers when they need to be playing 3-D chess. Leaving aside the impossibility of predicting Fed behavior, the reaction of inflation to that behavior, and the reaction of markets to inflation, what about all the other things that matter? If a thousand things play a part in determining the future direction of the economy and markets, what about the other 999? What about the impact of wage negotiations, the mid-term elections, the war in Ukraine, and the price of oil?

The truth is that humans can hold only a few things in their minds at any given time. **It's hard to factor in a large number of considerations and especially to understand how a large number of things will interact (correlation is always the real stumper).**

Even if you somehow manage to get an economic forecast correct, that's only half the battle. You still need to anticipate how that economic activity will translate into a market outcome. This requires an entirely different forecast, also involving innumerable variables, many of which pertain to psychology and thus are practically unknowable. According to his student Warren Buffett, Ben Graham said, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." How can investors' short-run choices be predicted? **Some economic forecasters correctly concluded that the actions of the Fed and Treasury announced in March 2020 would rescue the U.S. economy and trigger an economic recovery. But I'm not aware of anyone who predicted the torrid bull market that lifted off well before the recovery got underway**.

As I've described before, in 2016 Buffett shared with me his view of macro forecasts. "For a piece of information to be desirable, it has to satisfy two criteria: It has to be **important**, and it has to be **knowable**."

- **Of course, the macro outlook is important.** These days it seems as if investors hang on every forecaster's word, macro event, and twitch on the part of the Fed. Unlike my early days in this business, it seems like macro is everything and corporate developments count for relatively little.
- **But I agree strongly with Buffett that the macro future isn't knowable**, or at least almost no one can consistently know more about it than the mass of investors, which is what matters in trying to gain a knowledge advantage and make superior investment decisions.

Clearly, Buffett's name goes at the top of the list of investors who've succeeded by shunning macro forecasts and instead focusing on learning more than others about "the micro": companies, industries and securities.

* * *

In a 2001 memo called *What's It All About, Alpha?*, I introduced the concept of the "I know" school and the "I don't know" school, and in 2004, I elaborated on this at length in *Us and Them*. To close the current memo, I'm going to insert some of what I wrote in the latter about the two schools:

> Most of the investors I've met over the years have belonged to the "I know" school. This was particularly true in 1968-78, when I analyzed equities, and even in 1978-95, when I had switched to non-mainstream investments but still worked at equity-centric money management firms.
>
> It's easy to identify members of the "I know" school:
>
> - They think knowledge of the future direction of economies, interest rates, markets and widely followed mainstream stocks is essential for investment success.
> - They're confident it can be achieved.
> - They know they can do it.
> - They're aware that lots of other people are trying to do it too, but they figure either (a) everyone can be successful at the same time, or (b) only a few can be, but they're among them.
> - They're comfortable investing based on their opinions regarding the future.
> - They're also glad to share their views with others, even though correct forecasts should be of such great value that no one would give them away gratis.
> - They rarely look back to rigorously assess their record as forecasters.
>
> "Confident" is the key word for describing members of this school. For the "I don't know" school, on the other hand, the word – especially when dealing with the macro-future – is "guarded." **Its adherents generally believe you can't know the future; you don't have to know the future; and the proper goal is to do the best possible job of investing in the absence of that knowledge.**
>
> As a member of the "I know" school, you get to opine on the future (and maybe have people take notes). You may be sought out for your opinions and considered a desirable dinner guest . . . especially when the stock market's going up.
>
> Join the "I don't know" school and the results are more mixed. You'll soon tire of saying "I don't know" to friends and strangers alike. After a while, even relatives will stop asking where you think the market's going. You'll never get to enjoy that 1-in-1,000 moment when your forecast comes true and *The Wall Street Journal* runs your picture. On the other hand, you'll be spared all those times when forecasts miss the mark, as well as the losses that can result from investing based on over-rated knowledge of the future. **But how do you think it feels to have prospective clients ask about your investment outlook and have to say, "I have no idea"?**
> For me, the bottom line on which school is best comes from the late Stanford behaviorist, Amos Tversky: **"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."**

It's certainly standard practice in the investment management business to come up with macro forecasts, share them on request, and bet clients' money on them. It also seems conventional for money managers to trust in forecasts, especially their own. Not doing so would introduce enormous dissonance, as described above. But is their belief justified by the facts? I'm eager to hear what you think.

* * *

A few years ago, a highly respected sell-side economist with whom I became friendly during my early Citibank days called me with an important message: "You've changed my life," he said. "I've stopped making forecasts. Instead, I just tell people what's going on today and what I see as the possible implications for the future. Life is so much better." Can I help you reach the same state of bliss?

September 8, 2022

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Memo to: Oaktree Clients

From: Howard Marks

Re: What Really Matters?

I've gathered a few ideas from several of my memos this year – plus some recent musings and conversations – to form the subject of this memo: what really matters or should matter for investors. I'll start by examining a number of things that I think don't matter.

What Doesn't Matter: Short-Term Events

In *The Illusion of Knowledge* (September 2022), I railed against macro forecasting, which in our profession mostly concerns the next year or two. And in *I Beg to Differ* (July 2022), I discussed the questions I was asked most frequently at Oaktree's June 21 conference in London: How bad will inflation get? How much will the Fed raise interest rates to fight it? Will those increases cause a recession? How bad and for how long? The bottom line, I told the attendees, was that these things all relate to the short term, and this is what I know about the short term:

- Most investors can't do a superior job of predicting short-term phenomena like these.
- Thus, they shouldn't put much stock in opinions on these subjects (theirs or those of others).
- They're unlikely to make major changes in their portfolios in response to these opinions.
- The changes they do make are unlikely to be consistently right.
- Thus, these aren't the things that matter.

Consider an example. In response to the first tremors of the Global Financial Crisis, the Federal Reserve began to cut the fed funds rate in 3Q2007. They then lowered it to zero around the end of 2008 and left it there for seven years. In late 2015, virtually the only question I got was "When will the first rate increase occur?" My answer was always the same: "Why do you care? If I say 'February,' what will you do? And if I later change my mind and say 'May,' what will you do differently? If everyone knows rates are about to rise, what difference does it make which month the process starts?" No one ever offered a convincing answer. Investors probably think asking such questions is part of behaving professionally, but I doubt they could explain why.

The vast majority of investors can't know for sure what macro events lie just ahead or how the markets will react to the things that do happen. In *The Illusion of Knowledge*, I wrote at length about the way unforeseen events make a hash of economic and market forecasts. In summary, most forecasts are extrapolations, and most of the time things don't change, so extrapolations are usually correct, but not particularly profitable. On the other hand, accurate forecasts of deviations from trend can be very profitable, but they're hard to make and hard to act on. These are some of the reasons why most people can't predict the future well enough to repeatably produce superior performance.

Why is doing this so hard? Don't most of us know what events are likely to transpire? Can't we just buy the securities of the companies that are most likely to benefit from those events? In the long run, maybe, but I want to turn to a theme that Bruce Karsh has been emphasizing lately, regarding a major reason why it's particularly challenging to profit from a short-term focus: **It's very difficult to know which expectations regarding events are already incorporated in security prices.**

One of the critical mistakes people are guilty of – we see it all the time in the media – is believing that changes in security prices are the result of events: that favorable events lead to rising prices and negative events lead to falling prices. I think that's what most people believe – especially first-level thinkers – but that's not right. **Security prices are determined by events and how investors react to those events, which is largely a function of how the events stack up against investors' expectations.**

How can we explain the company that reports higher earnings, only to see its stock price drop? The answer, of course, is that the reported improvement fell short of expectations and thus disappointed investors. So, at the most elementary level, it's not whether the event is simply positive or not, but how the event compares with what was expected.

In my earliest working years, I used to spend a few minutes each day looking over the earnings reports printed in *The Wall Street Journal*. But after a while, it dawned on me that since I didn't know what numbers had been expected, I had no idea whether an announcement from a company I didn't follow was good news or bad.

Investors can become expert regarding a few companies and their securities, but no one is likely to know enough about macro events to (a) be able to understand the macro expectations that underlie the prices of securities, (b) anticipate the broad events, and (c) predict how those securities will react. Where can a prospective buyer look to find out what the investors who set securities prices already anticipate in terms of inflation, GDP, or unemployment? Inferences regarding expectations can sometimes be drawn from asset prices, but the inferred levels often aren't proved correct when the actual results come in.

Further, in the short term, security prices are highly susceptible to random and exogenous events that can swamp the impact of fundamental events. **Macro events and the ups and downs of companies' near-term fortunes are unpredictable and not necessarily indicative of – or relevant to – companies' long-term prospects. So little attention should be paid to them.** For example, companies often deliberately reduce current earnings by investing in the future of their businesses; thus, low reported earnings can imply high future earnings, not continued low earnings. To know the difference, you have to have an in-depth understanding of the company.

No one should be fooled into thinking security pricing is a dependable process that accurately follows a set of rules. Events are unpredictable; they can be altered by unpredictable influences; and investors' reactions to the events that occur are unpredictable. Due to the presence of so much uncertainty, most investors are unable to improve their results by focusing on the short term.

It's clear from observation that security prices fluctuate much more than economic output or company profits. **What accounts for this? It must be the fact that, in the short term, the ups and downs of prices are influenced far more by swings in investor psychology than by changes in companies' long-term prospects. Because swings in psychology matter more in the near term than changes in fundamentals – and are so hard to predict – most short-term trading is a waste of time . . . or worse.**

<u>What Doesn't Matter: The Trading Mentality</u>

Over the years, my memos have often included some of my father's jokes from the 1950s, based on my strong belief that humor often reflects truths about the human condition. Given its relevance here, I'm going to devote a bit of space to a joke I've shared before:

> Two friends meet in the street, and Joe asks Sam what's new. "Oh," he replies, "I just got a case of great sardines."
>
> Joe: Great, I love sardines. I'll take some. How much are they?
>
> Sam: $10,000 a tin.
>
> Joe: What! How can a tin of sardines cost $10,000?
>
> Sam: These are the greatest sardines in the world. Each one is a pedigreed purebred, with papers. They were caught by net, not hook; deboned by hand; and packed in the finest extra-virgin olive oil. And the label was painted by a well-known artist. They're a bargain at $10,000.
>
> Joe: But who would ever eat $10,000 sardines?
>
> Sam: Oh, these aren't eating sardines; they're trading sardines.

I include this old joke because I believe most people treat stocks and bonds like something to trade, not something to own.

If you ask Warren Buffett to describe the foundation of his approach to investing, he'll probably start by insisting that stocks should be thought of as ownership interests in companies. Most people don't start companies with the goal of selling them in the short term, but rather they seek to operate them, enjoy profitability, and expand the business. Of course, founders do these things to ultimately make money, but they're likely to view the money as the byproduct of having run a successful business. Buffett says people who buy stocks should think of themselves as partners of owners with whom they share goals.

But I think that's rarely the case. **Most people buy stocks with the goal of selling them at a higher price, thinking they're for trading, not for owning.** This means they abandon the owner mentality and instead act like gamblers or speculators who bet on stock price moves. The results are often unpleasant.

> The DALBAR Institute 2012 study showed that investors receive three percentage points less per year than the S&P 500 generated from 1992 to 2012, and the average holding period for a typical investor is six months. Six Months!! When you hold a stock for less than a year, you are not using the stock market to acquire business ownership positions and participate in the growth of that business. Instead, you are just guessing at short-term news and expectations, and your returns are based on how other people react to that news information. In aggregate, that kind of attitude gets you three percentage points less per year than you'd get from doing nothing at all beyond making the initial investment in the index fund of the S&P 500. ("Fidelity's Best Investors Are Dead," *The Conservative Income Investor*, April 8, 2020)

To me, buying for a short-term trade equates to forgetting about your sports team's chances of winning the championship and instead betting on who's going to succeed in the next play, period, or inning.

Let's think about the logic. You buy a stock because you think it's worth more than you have to pay for it, whereas the seller considers it fully priced. Someday, if things go well, it'll become fully priced, in your opinion, meaning you'll sell it. The person you sell it to, however, will buy it because he thinks it's worth still more. We used to talk about this process as being reliant on the Greater Fool Theory: No matter what price I pay for a stock, there will always be someone who will buy it from me for more, despite the fact that I'm selling because I've concluded that it has reached full value.

Every buyer is motivated by the belief that the stock will eventually be worth more than today's price (a view the seller presumably doesn't share). The key question is what type of thinking underlies these purchases. **Are the buyers buying because this is a company they'd like to own a piece of for years? Or are they merely betting that the price will go up?** The transactions may look the same from the outside, but I wonder about the thought process and thus the soundness of the logic.

Each time a stock is traded, one side is wrong and one is right. But if what you're doing is betting on trends in popularity, and thus the direction of price moves over the next month, quarter, or year, is it realistic to believe you'll be right more often than the person on the other side of the trade? Maybe the decline of active management can be attributed to the many active managers who placed bets on the direction of stock prices in the short term, instead of picking companies they wanted to own part of for years. It's all a matter of the underlying mentality.

I had a long debate on this topic with my father back in 1969, when I lived with him during my first months at First National City Bank. (It's amazing for me to think back to those days; he was so much younger than I am today.) I told him I thought buying a stock should be motivated by something other than the hope that the price would rise, and I suggested this might be the expectation that dividends would increase over time. He countered that no one buys stocks for the dividends – they buy because they think the price will go up. But what would trigger the rise?

Wanting to own a business for its commercial merit and long-term earnings potential is a good reason to be a stockholder, and if these expectations are borne out, a good reason to believe the stock price will rise. In the absence of that, buying in the hope of appreciation merely amounts to trying to guess which industries and companies investors will favor in the future. Ben Graham famously said, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." **While none of this is easy, as Charlie Munger once told me, carefully weighing long-term merit should produce better results than trying to guess at short-term swings in popularity.**

<u>What Doesn't Matter: Short-Term Performance</u>

Given the possible contributors to short-term investment performance, reported results can present a highly misleading picture, and here I'm talking mostly about superior gains in good times. I feel there are three ingredients for success during good times – aggressiveness, timing, and skill – and if you have enough aggressiveness at the right time, you don't need that much skill. We all know that in good times, the highest returns often go to the person whose portfolio incorporates the most risk, beta, and correlation. Having such a portfolio isn't a mark of distinction or insight if the investor is a perma-bull who's always positioned aggressively. Finally, random events can have an overwhelming impact on returns – in either direction – in a given quarter or year.

One of the recurring themes in my memos is the idea that the quality of a decision cannot be determined from the outcome alone. Decisions often lead to negative outcomes even when they're well-reasoned and based on all the available information. On the other hand, we all know people – even occasionally ourselves – who've been right for the wrong reason. Hidden information and random developments can frustrate even the best thinkers' decisions. (However, when outcomes are considered over a long period of time and a large number of trials, the better decision maker is overwhelmingly likely to have a higher proportion of successes.)

Obviously, no one should attach much significance to returns in one quarter or year. Investment performance is simply one result drawn from the full range of returns that could have materialized, and in the short term, it can be heavily influenced by random events. Thus, a single quarter's return is likely to be a very weak indicator of an investor's ability, if that. Deciding whether a manager has special skill – or whether an asset allocation is appropriate for the long run – on the basis of one quarter or year is like forming an opinion of a baseball player on the basis of one trip to the plate, or of a racehorse based on one race.

We know short-term performance doesn't matter much. And yet, most of the investment committees I've sat on have had the latest quarter's performance as the first item on the agenda and devoted a meaningful portion of each meeting to it. The discussion is usually extensive, but it rarely leads to significant action. So why do we keep doing it? For the same reasons investors pay attention to forecasting, as described in *The Illusion of Knowledge*: "everyone does it," and "it would be irresponsible not to."

What Doesn't Matter: Volatility

I haven't written much about volatility, other than to say I strongly disagree with people who consider it the definition or essence of risk. I've described my belief that the academics who developed the Chicago School theory of investment in the early 1960s (a) wanted to examine the relationship between investment returns and risk, (b) needed a number quantifying risk that they could put into their calculations, and (c) undoubtedly chose volatility as a proxy for risk for the simple reason that it was the only quantifiable metric available. I define risk as the probability of a bad outcome, and volatility is, at best, an indicator of the presence of risk. But volatility is not risk. That's all I'm going to say on that subject.

What I want to talk about here is the extent to which thinking and caring about volatility has warped the investing world over the 50-plus years that I've been in it. It was a great advantage for me to have attended the Graduate School of Business at the University of Chicago in the late '60s and to have been part of one of the very first classes that was taught the new theories. I learned about the efficient market hypothesis, the capital asset pricing model, the random walk, the importance of risk aversion, and the role of volatility as risk. While volatility wasn't a topic of conversation when I got into the real world of investing in 1969, practice soon caught up with theory.

In particular, the Sharpe ratio was adopted as the measure of risk-adjusted return. It's the ratio of a portfolio's excess return (the part of its return that exceeds the yield on T-bills) to its volatility. The more return per unit of volatility, the higher the risk-adjusted return. Risk adjustment is an essential concept, and returns should absolutely be evaluated relative to the risk that was taken to achieve them. Everyone cites Sharpe ratios, including Oaktree, because it's the only quantitative tool available for the job. (If investors, consultants, and clients didn't use the Sharpe ratio, they'd have no metric at all, and if they tried to substitute fundamental riskiness for volatility in their assessments, they'd find that there's no way to quantify it.) **The Sharpe ratio may hint at risk-adjusted performance in the same way that volatility hints at risk, but since volatility isn't risk, the Sharpe ratio is a very imperfect measure.**

Take, for example, one of the asset classes I started working with in 1978: high yield bonds. At Oaktree, we think moderately-above-benchmark returns can be produced with substantially less risk than the benchmark, and this shows up in superior Sharpe ratios. But the real risk in high yield bonds – the one we care about and have a history of reducing – is the risk of default. We don't much care about reducing volatility, and we don't take conscious steps to do so. We believe high Sharpe ratios can result from – and perhaps are correlated with – the actions we take to reduce defaults.

Volatility is particularly irrelevant in our field of fixed income or "credit." Bonds, notes, and loans represent contractual promises of periodic interest and repayment at maturity. **Most of the time when you buy a bond with an 8% yield, you'll basically get the 8% yield over its life, regardless of whether the bond price goes up or down in the interim.** I say "basically" because, if the price falls, you'll have the opportunity to reinvest the interest payments at yields above 8%, so your holding-period return will creep up. Thus, the downward price volatility that so many revile is actually a good thing – as long as it doesn't presage defaults. (Note that, as indicated in this paragraph, "volatility" is often a misnomer. Strategists and the media often warn that "there may be volatility ahead." What they really mean is "there may be price declines ahead." No one worries about, or minds experiencing, volatility to the upside.)

It's essential to recognize that protection from volatility generally isn't a free good. Reducing volatility for its own sake is a suboptimizing strategy: It should be presumed that favoring lower-volatility assets and approaches will – all things being equal – lead to lower returns. Only managers with superior skill, or alpha (see page 11), will be able to overcome this negative presumption and reduce return less than they reduce volatility.

Nevertheless, since many clients, bosses, and other constituents are uncomfortable with radical ups and downs (well, mostly with downs), asset managers often take steps to reduce volatility. Consider what happened after institutional investors began to pile into hedge funds following the three-year decline of stocks brought on by the bursting of the tech bubble in 2000. (This was the first three-year decline since 1939-41.) Hedge funds – previously members of a cottage industry where most funds had a few hundred million dollars of capital from wealthy individuals – did much better than stocks in the downdraft. Institutions were attracted to these funds' low volatility, and thus invested billions in them.

The average hedge fund delivered the stability the institutions wanted. But somewhere in the shuffle, the idea of earning high returns with low volatility got lost. Instead, hedge fund managers pursued low volatility as a goal in itself, since they knew it was what the institutions were after. As a result, over roughly the last 18 years, the average hedge fund delivered the low volatility that was desired, but it was accompanied by modest single-digit returns. No miracle there.

Why do I recite all this? Because volatility is just a temporary phenomenon (assuming you survive it financially), and most investors shouldn't attach as much importance to it as they seem to. As I wrote in *I Beg to Differ*, many investors have the luxury of being able to focus exclusively on the long term . . . if they will take advantage of it. Volatility should be less of a concern for investors:

- whose entities are long-lived, like life insurance companies, endowments, and pension funds;
- whose capital isn't subject to lump-sum withdrawal;
- whose essential activities won't be jeopardized by downward fluctuations;
- who don't have to worry about being forced into mistakes by their constituents; and
- who haven't levered up with debt that might have to be repaid in the short run.

Most investors lack some of these things, and few have them all. But to the extent these characteristics are present, investors should take advantage of their ability to withstand volatility, since many investments with the potential for high returns might be susceptible to substantial fluctuations.

Warren Buffett always puts it best, and on this topic he usefully said, "We prefer a lumpy 15% return to a smooth 12% return." Investors who'd rather have the reverse – who find a smooth 12% preferable to a lumpy 15% – should ask themselves whether their aversion to volatility is mostly financial or mostly emotional.

Of course, the choices made by employees, investment committee members, and hired investment managers may have to reflect real-world considerations. People in charge of institutional portfolios can have valid reasons for avoiding ups and downs that their organizations or clients might be able to stomach in financial terms but would still find unpleasant. All anyone can do is the best they can under their particular circumstances. **But my bottom line is this: In many cases, people accord volatility far more importance than they should.**

An Aside

While I'm on the subject of volatility, I want to turn to an area that hasn't reported much of it of late: private investment funds. The first nine months of 2022 constituted one of the worst periods on record for both stocks and bonds. Yet many private equity and private debt funds are reporting only small losses for the year to date. I'm often asked what this means, and whether it reflects reality.

Maybe the performance of private funds is being reported accurately. (I know we believe ours is.) But I recently came across an interesting *Financial Times* article provocatively titled, "The volatility laundering, return manipulation and 'phoney happiness' of private equity," by Robin Wigglesworth. Here's some of its content:

> The widening performance gap between public and private markets is a huge topic these days. Investors are often seen as the gormless [foolish] dupes falling for the "return manipulation" of cunning private equity tycoons. But what if they are co-conspirators? . . .
>
> That's what a new paper from three academics at the University of Florida argues. Based on nearly two decades worth of private equity real estate funds data, Blake Jackson, David Ling and Andy Naranjo conclude that "private equity fund managers manipulate returns to cater to their investors."
>
> **. . . Jackson, Ling and Naranjo's . . . central conclusion is that "GPs do not appear to manipulate interim returns to fool their LPs, but rather because their LPs want them to do so".**
>
>> Similar to the idea that banks design financial products to cater to yield-seeking investors or firms issue dividends to cater to investor demand for dividend payments, we argue that PE fund managers boost interim performance reports to cater to some investors' demand for manipulated returns.
>>
>> . . . **If a GP boosts or smooths returns, . . . investment managers within LP organizations can report artificially higher Sharpe ratios, alphas, and top-**

> **line returns, such as IRRs, to their trustees or other overseers.** In doing so, these investment managers, whose median tenure of four years often expires years before the ultimate returns of a PE fund are realized, might improve their internal job security or potential labor market outcomes. . . .
>
> This probably helps explain why private equity firms on average actually reported gains of 1.6 per cent in the first quarter of 2022 and only some modest mark downwards since then, despite global equities losing 22 per cent of their value this year. (November 2, 2022. Emphasis added)

If both GPs and LPs are happy with returns that seem unusually good, might the result be suspect? Is the performance of private assets being stated accurately? Is the low volatility being reported genuine? If the current business climate is challenging, shouldn't that affect the prices of public and private investments alike?

But there's another series of relevant questions: Mightn't it be fair for GPs to decline to mark down private investments in companies that have experienced short-term weakness but whose long-term prospects remain bright? And while private investments might not have been marked down enough this year, isn't it true that the prices of public securities are more volatile than they should be, overstating the changes in long-term value? I certainly think public security prices reflect psychological swings that are often excessive. Should the prices of private investments emulate this?

As with most things, any inaccuracy in reporting will eventually come to light. Eventually, private debt will mature, and private equity holdings will have to be sold. If the returns being reported this year understate the real declines in value, performance from here on out will likely look surprisingly poor. And I'm sure this will lead plenty of academics (and maybe a few regulators) to question whether the pricing of private investments in 2022 was too high. We'll see.

What Doesn't Matter: Hyper-Activity

In *Selling Out* (January 2022), I expressed my strong view that most investors trade too much. Since it's hard to make multiple consecutive decisions correctly, and trading costs money and is often likely to result from an investor's emotional swings, it's better to do less of it.

When I was a boy, there was a popular saying: Don't just sit there; do something. But for investing, I'd invert it: Don't just do something; sit there. Develop the mindset that you don't make money on what you buy and sell; you make money (hopefully) on what you hold. Think more. Trade less. Make fewer, but more consequential, trades. Over-diversification reduces the importance of each trade; thus it can allow investors to take actions without adequate investigation or great conviction. I think most portfolios are overdiversified and over-traded.

I devoted a good portion of *The Illusion of Knowledge* and *Selling Out* to warning investors about how difficult it is to improve returns through short-term market timing, and I quoted the great investor Bill Miller: "Time, not timing, is key to building wealth in the stock market."

On this subject, I was recently asked by a consultant, "If you don't try to get in and out of the market as appropriate, how do you earn your fees?" My answer was that it's our job to assemble portfolios that will perform well over the long run, and market timing is unlikely to add to the outcome unless it can be done well, which I'm not convinced is usually the case. "What about you?" I asked. "If you help a client establish an appropriate asset allocation, does it follow that you're not earning your fees if you don't change it a month later?"

Likewise, the day *The Illusion of Knowledge* came out, an old friend asked me, "But you have to take a position [on short-run events], don't you?" My answer, predictably, was, "No, not if you don't have an advantage when doing so. Why would you bet on the outcome of a coin toss, especially if it cost money to play?"

I'll end my discussion of this subject with a wonderful citation:

> A news item that has gotten a lot of attention recently concerned an internal performance review of Fidelity accounts to determine which type of investors received the best returns between 2003 and 2013. The customer account audit revealed that the best investors were either dead or inactive – the people who switched jobs and "forgot" about an old 401(k) leaving the current options in place, or the people who died and the assets were frozen while the estate handled the assets. ("Fidelity's Best Investors Are Dead," *The Conservative Income Investor*, April 8, 2020)

Since the journalists have been unable to find the Fidelity study, and apparently so has Fidelity, the story is probably apocryphal. But I still like the idea, since the conclusion is so much in line with my thinking. **I'm not saying it's worth dying to improve investment performance, but it might be a good idea for investors to simulate that condition by sitting on their hands.**

<u>So What Does Matter?</u>

What really matters is the performance of your holdings over the next five or ten years (or more) and how the value at the end of the period compares to the amount you invested and to your needs. Some people say the long run is a series of short runs, and if you get those right, you'll enjoy success in the long run. They might think the route to success consists of trading often in order to capitalize on relative value assessments, predictions regarding swings in popularity, and forecasts of macro events. I obviously do not.

Most individual investors and anyone who understands the limitations regarding outperformance would probably be best off holding index funds over the long run. Investment professionals and others who feel they need or want to engage in active management might benefit from the following suggestions.

I think most people would be more successful if they focused less on the short run or macro trends and instead worked hard to gain superior insight concerning the outlook for fundamentals over multi-year periods in the future. They should:

- study companies and securities, assessing things such as their earnings potential;
- buy the ones that can be purchased at attractive prices relative to their potential;
- hold onto them as long as the company's earnings outlook and the attractiveness of the price remain intact; and
- make changes only when those things can't be reconfirmed, or when something better comes along.

At the London conference mentioned on page one – while I was discussing (and discouraging) paying attention to the short run – I said that at Oaktree we consider it our job to (a) buy debt that will be serviced as promised (or will return the same amount or more if not) and (b) invest in companies that will become more valuable over time. I'll stick with that.

The above description of the investor's job is quite simple . . . some might say simplistic. And it is. Setting out the goals and the process in broad terms is easy. The hard part is executing better than most people: That's the only route to market-beating performance. **Since average decision-making is reflected in security prices and produces average performance, superior results have to be based on superior insight.** But I can't tell you how to do these things better than the average investor. There's a lot more to the process, and I'm going to outline some of what I think are key elements to remember. You'll recognize recurring themes here, from other memos and from earlier pages in this one, but I make no apology for dwelling on things that are important:

- Forget the short run – only the long run matters. Think of securities as interests in companies, not trading cards.
- Decide whether you believe in market efficiency. If so, is your market sufficiently inefficient to permit outperformance, and are you up to the task of exploiting it?
- Decide whether your approach will lean more toward aggressiveness or defensiveness. Will you try to find more and bigger winners or focus on avoiding losers, or both? Will you try to make more on the way up or lose less on the down, or both? (Hint: "both" is much harder to achieve than one or the other.) In general, people's investment styles should fit their personalities.
- Think about what your normal risk posture should be – your normal balance between aggressiveness and defensiveness – based on your or your clients' financial position, needs, aspirations, and ability to live with fluctuations. Consider whether you'll vary your balance depending on what happens in the market.
- Adopt a healthy attitude toward return and risk. Understand that "the more return potential, the better" can be a dangerous rule to follow given that increased return potential is usually accompanied by increased risk. On the other hand, completely avoiding risk usually leads to avoiding return as well.
- Insist on an adequate margin of safety, or the ability to weather periods when things go less well than you expected.
- Stop trying to predict the macro; study the micro like mad in order to know your subject better than others. Understand that you can expect to succeed only if you have a knowledge advantage, and be realistic about whether you have it or not. Recognize that trying harder isn't enough. Accept my son Andrew's view that merely possessing "readily available quantitative information regarding the present" won't give you above average results, since everyone else has it.
- Recognize that psychology swings much more than fundamentals, and usually in the wrong direction or at the wrong time. Understand the importance of resisting those swings. Profit if you can by being counter-cyclical and contrarian.
- Study conditions in the investment environment – especially investor behavior – and consider where things stand in terms of the cycle. Understand that where the market stands in its cycle will strongly influence whether the odds are in your favor or against you.
- Buy debt when you like the yield, not for trading purposes. In other words, buy 9% bonds if you think the yield compensates you for the risk, and you'll be happy with 9%. Don't buy 9% bonds expecting to make 11% thanks to price appreciation resulting from declining interest rates.

Of critical importance, equity investors should make their primary goals (a) participating in the secular growth of economies and companies and (b) benefiting from the wonder of compounding. Think about the 10.5% yearly return of the S&P 500 Index (or its predecessors) since 1926 and the fact that this would have turned $1 into over $13,000 by now, even though the period witnessed 16 recessions, one Great Depression, several wars, one World War, a global pandemic, and many instances of geopolitical turmoil.

Think of participating in the long-term performance of the average as the main event and the active efforts to improve on it as "embroidery around the edges." This might be the reverse of most active investors' attitudes. Improving results through over- and underweighting, short-term trading, market timing, and other active measures isn't easy. **Believing you can do these things successfully requires the assumption that you're smarter than a bunch of very smart people. Think twice before proceeding, as the requirements for success are high (see below).**

Don't mess it up by over-trading. Think of buying and selling as an expense item, not a profit center. I love the idea of the automated factory of the future, with its one man and one dog; The dog's job is to keep the man from touching the machinery, and the man's job is to feed the dog. **Investors should find a way to keep their hands off their portfolios most of the time.**

<ins>A Special Word in Closing: Asymmetry</ins>

"Asymmetry" is a concept I've been conscious of for decades and consider more important with every passing year. It's my word for the essence of investment excellence and a standard against which investors should be measured.

First, some definitions:

- I'm going to talk below about whether an investor has "alpha." Alpha is technically defined as return in excess of the benchmark return, but I prefer to think of it as superior investing skill. It's the ability to find and exploit inefficiencies when they're present.
- Inefficiencies – mispricings or mistakes – represent instances when an asset's price diverges from its fair value. These divergences can show up as bargains or the opposite, over-pricings.
- Bargains will dependably perform better than other investments over time after adjustment for their riskiness. Over-pricings will do the opposite.
- "Beta" is an investor's or a portfolio's relative volatility, also described as relative sensitivity or systematic risk.

People who believe in the efficient market hypothesis think of a portfolio's return as the product of the market's return multiplied by the portfolio's beta. This is all it takes to explain results, since there are no mispricings to take advantage of in an efficient market (and so no such thing as alpha). **Thus, alpha is skill that enables an investor to produce performance better than that which is explained purely by market return and beta.** Another way to say this is that having alpha allows an investor to enjoy profit potential that is disproportionate to loss potential: asymmetry. In my view, asymmetry is present when an investor can repeatedly do some or all of the following:

- make more money in good markets than he gives back in bad markets,
- have more winners than losers,
- make more money on his winners than he loses on his losers,

- do well when his aggressive or defensive bias proves timely but not badly when it doesn't,
- do well when his sector or strategy is in favor but not badly when it isn't, and
- construct portfolios so that most of the surprises are on the upside.

For example, most of us have an inherent bias toward either aggressiveness or defensiveness. For this reason, it doesn't mean much if an aggressive investor outperforms in a good year or a defensive investor outperforms in a bad year. To determine whether they have alpha and produce asymmetry, we have to consider whether the aggressive investor is able to avoid the full loss that his aggressiveness alone would produce in a bad market and whether the defensive investor can avoid missing out on too much of the gain when the market does well. **In my opinion, "excellence" lies in asymmetry between the results in good and bad times.**

As I see it, if inefficiencies are present in an investor's market, and she has alpha, the impact will show up in asymmetrical returns. If her returns show no asymmetry, the investor doesn't have alpha (or perhaps there are no inefficiencies for her to identify). Flipping that over, if an investor doesn't have alpha, her returns won't be asymmetrical. It's as simple as that.

To simplify, here's how I think about asymmetry. This discussion is based on material I included in my 2018 book *Mastering the Market Cycle: Getting the Odds on Your Side*. While I may appear to be talking about one good year and one bad one, these observations can only be considered valid if these patterns hold over a meaningful number of years.

Let's consider a manager's performance:

Market performance	+10%	-10%
Manager A	+10%	-10%

The above manager clearly adds no value. You might as well invest in an index fund (probably at a much lower fee).

These two managers also add no value:

Market performance	+10%	-10%
Manager B	+5%	-5%
Manager C	+20%	-20%

Manager B is just a no-alpha manager with a beta of 0.5, and manager C is a no-alpha manager with a beta of 2.0. You could get the same results as manager B by putting half your capital in an index fund and keeping the rest under your mattress and in the case of manager C, by doubling your investment with borrowed capital and putting it all in an index fund.

These two managers, however, do have alpha, as they exhibit asymmetry:

Market performance	+10%	-10%
Manager D	+17%	-12%
Manager E	+9%	-3%

Both managers' returns reflect more of the market's gain in good times than they do its loss in bad ones. Manager D might be described as an aggressive manager with alpha; she achieves 170% of the market's return when the market rises but suffers only 120% of the loss when it falls. Manager E is a defensive manager with alpha; his returns reflect 90% of the gain in an up market but only 30% of the loss in a down market. These asymmetries can only be attributed to the presence of alpha. Risk-tolerant clients will prefer to invest with D, and risk-averse ones will prefer E.

This manager is truly exceptional:

Market performance	+10%	-10%
Manager F	+20%	-5%

She beat the market in both directions: She's up more than the market when it rises <u>and</u> down less when it falls. She's up so much in a good market that you might be tempted to describe her as aggressive. But since she's down less in a down market, that description won't hold. Either she doesn't have a bias in terms of aggressiveness versus defensiveness, or her alpha is great enough to offset it.

Finally, here's one of the greatest managers of all time:

Market performance	+10%	-10%
Manager G	+20%	+5%

Manager G is up in good and bad markets alike. He clearly doesn't have an aggressiveness/defensiveness bias, since his performance is exceptional in both markets. His alpha is sufficient to enable him to buck the trend and achieve a positive return in a down year. When you find Manager G, you should (a) do extensive due diligence regarding his reported performance, (b) if the numbers hold up, invest a lot of money with him, (c) hope he won't accept so much money that his edge goes away, and (d) send me his number.

*   *   *

What matters most? Asymmetry.

- In sum, asymmetry shows up in a manager's ability to do very well when things go his way and not too bad when they don't.

- A great adage says, “Never confuse brains and a bull market.” Managers with the skill needed to produce asymmetry are special because they’re able to fashion good gains from sources other than market advances.
- **When you think about it, the active investment business is, at its heart, completely about asymmetry. If a manager’s performance doesn’t exceed what can be explained by market returns and his relative risk posture – which stems from his choice of market sector, tactics, and level of aggressiveness – he simply hasn’t earned his fees.**

Without asymmetry (see Managers A, B, and C on page 12), active management delivers no value and deserves no fees. **Indeed, all the choices an active investor makes will be for naught if he doesn’t possess superior skill or insight.** By definition, average investors and below-average investors don’t have alpha and can’t produce asymmetry.

The big question is how to achieve asymmetry. Most of the things people focus on – the things I describe on pages one through nine as not mattering – can’t provide it. As I’ve said before, the average of all investors’ thinking produces market prices and, obviously, average performance. **Asymmetry can only be demonstrated by the relatively few people with <u>superior</u> skill and insight.** The key lies in finding them.

November 22, 2022

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Memo to: Oaktree Clients

From: Howard Marks

Re: Sea Change

> **sea change (idiom):** a complete transformation, a radical change of direction in attitude, goals . . . (*Grammarist*)

In my 53 years in the investment world, I've seen a number of economic cycles, pendulum swings, manias and panics, bubbles and crashes, **but I remember only two real sea changes. I think we may be in the midst of a third one today.**

As I've recounted many times in my memos, when I joined the investment management industry in 1969, many banks – like the one I worked for at the time – focused their equity portfolios on the so-called "Nifty Fifty." The Nifty Fifty comprised the stocks of companies that were considered the best and fastest-growing – so good that nothing bad could ever happen to them. For these stocks, everyone was sure there was "no price too high." But if you bought the Nifty Fifty when I started at the bank and held them until 1974, you were sitting on losses of more than 90% . . . from owning pieces of the best companies in America. Perceived quality, it turned out, wasn't synonymous with safety or with successful investment.

Meanwhile, over in bond-land, a security with a rating of single-B was described by Moody's as "failing to possess the characteristics of a desirable investment." Non-investment grade bonds – those rated double-B and below – were off-limits to fiduciaries, since proper financial behavior mandated the avoidance of risk. For this reason, what soon became known as high yield bonds couldn't be sold as new issues. But in the mid-1970s, Michael Milken and a few others had the idea that it should be possible to issue non-investment grade bonds – and to invest in them prudently – if the bonds offered enough interest to compensate for the risk of default. In 1978, I started investing in these securities – the bonds of perhaps America's riskiest public companies – and I was making money steadily and safely.

In other words, whereas prudent bond investing had previously consisted of buying only presumedly safe investment grade bonds, investment managers could now prudently buy bonds of almost any quality as long as they were adequately compensated for the attendant risk. The U.S. high yield bond universe amounted to about $2 billion when I first got involved, and today it stands at roughly $1.2 trillion.

This clearly represented a major change in direction for the business of investing. But that's not the end of it. Prior to the inception of high yield bond issuance, companies could only be acquired by larger firms – those that were able to pay with cash on hand or borrow large amounts of money and still retain their investment grade ratings. But with the ability to issue high yield bonds, smaller firms could now acquire larger ones by using heavy leverage, since there was no longer a need to possess or maintain an investment grade rating. This change permitted, in particular, the growth of leveraged buyouts and what's now called the private equity industry.

However, the most important aspect of this change didn't relate to high yield bonds, or to private equity, but rather to the adoption of a new investor mentality. Now risk wasn't necessarily avoided, but rather considered relative to return and hopefully borne intelligently. This new risk/return mindset was critical in the development of many new types of investment, such as distressed debt, mortgage backed securities, structured credit, and private lending. It's no exaggeration to say today's investment world bears almost no resemblance to that of 50 years ago. **Young people joining the industry today would likely be shocked to learn that, back then, investors didn't think in risk/return terms. Now that's all we do. Ergo, a sea change.**

At roughly the same time, big changes were underway in the macroeconomic world. I think it all started with the OPEC oil embargo of 1973-74, which caused the price of a barrel of oil to jump from roughly $24 to almost $65 in less than a year. This spike raised the cost of many goods and ignited rapid inflation. Because the U.S. private sector in the 1970s was much more unionized than it is now and many collective bargaining agreements contained automatic cost-of-living adjustments, rising inflation triggered wage increases, which exacerbated inflation and led to yet more wage increases. This seemingly unstoppable upward spiral kindled strong inflationary expectations, which in many cases became self-fulfilling, as is their nature.

The year-over-year increase in the Consumer Price Index, which was 3.2% in 1972, rose to 11.0% by 1974, receded to the range of 6-9% for four years, and then rebounded to 11.4% in 1979 and 13.5% in 1980. There was great despair, as no relief was forthcoming from inflation-fighting tools ranging from WIN ("Whip Inflation Now") buttons to price controls to a federal funds rate that reached 13% in 1974. It took the appointment of Paul Volcker as Fed chairman in 1979 and the determination he showed in raising the fed funds rate to 20% in 1980 to get inflation under control and extinguish inflationary psychology. As a result, inflation was back down to 3.2% by the end of 1983.

Volcker's success in bringing inflation under control allowed the Fed to reduce the fed funds rate to the high single digits and keep it there over the rest of the 1980s, before dropping it to the mid-single digits in the '90s. **His actions ushered in a declining-interest-rate environment that prevailed for four decades** (much more on this in the section that follows). **I consider this the second sea change I've seen in my career.**

The long-term decline in interest rates began just a few years after the advent of risk/return thinking, and I view the combination of the two as having given rise to (a) the rebirth of optimism among investors, (b) the pursuit of profit through aggressive investment vehicles, and (c) an incredible four decades for the stock market. The S&P 500 Index rose from a low of 102 in August 1982 to 4,796 at the beginning of 2022, for a compound annual return of 10.3% per year. What a period! There can be no greater financial and investment career luck than to have participated in it.

An Incredible Tailwind

What are the factors that gave rise to investors' success over the last 40 years? We saw major contributions from (a) the economic growth and preeminence of the U.S.; (b) the incredible performance of our greatest companies; (c) gains in technology, productivity and management techniques; and (d) the benefits of globalization. **However, I'd be surprised if 40 years of declining interest rates didn't play the greatest role of all.**

In the 1970s, I had a loan from a Chicago bank, with an interest rate of "three-quarters over prime." (We don't hear much about the prime rate anymore, but it was the benchmark interest rate – the predecessor of LIBOR – at which the money-center banks would lend to their best customers.) I received a notice from the bank each time my rate changed, and I framed the one that marked the high point in December 1980: It told me the interest rate on my loan had risen to 22.25%! Four decades later, I was able to borrow at just 2.25%, fixed for 10 years. This represented a decline of 2,000 basis points. Miraculous!

What are the effects of declining interest rates?

- They accelerate the growth of the economy by making it cheaper for consumers to buy on credit and for companies to invest in facilities, equipment, and inventory.
- They provide a subsidy to borrowers (at the expense of lenders and savers).
- They reduce businesses' cost of capital and thus increase their profitability.
- They increase the fair value of assets. (The theoretical value of an asset is defined as the discounted present value of its future cash flows. The lower the discount rate, the higher the present value.) Thus, as interest rates fall, valuation parameters such as p/e ratios and enterprise values rise, and cap rates on real estate decline.
- They reduce the prospective returns investors demand from investments they're considering, thereby increasing the prices they'll pay. This can be seen most directly in the bond market – everyone knows it's "rates down; prices up" – but it works throughout the investment world.
- By lifting asset prices, they create a "wealth effect" that makes people feel richer and thus more willing to spend.
- Finally, by simultaneously increasing asset values and reducing borrowing costs, they produce a bonanza for those who buy assets using leverage.

I want to spend more time on that last point. Think about a buyer who employs leverage in a declining-rate environment:

- He analyzes a company, concludes that he can make 10% a year on it, and decides to buy it.
- Then he asks his head of capital markets how much it would cost to borrow 75% of the money. When he's told it's 8%, it's full speed ahead. Earning 10% on three-quarters of the capital that's borrowed at 8% would lever up the return on the other one-quarter (his equity) to 16%.
- Banks compete to make the loan, and the result is an interest rate of 7% instead of 8%, making the investment even more profitable (a 19% levered return).
- The interest cost on his floating-rate debt declines over time, and when his fixed-rate debt matures, he finds he can roll it over at 5%. Now the deal is a home run (a 25% levered return, all else being equal).

This narrative ignores the beneficial impact of declining interest rates on both the profitability of the company he bought and the market value of that company. Is it any wonder then that private equity and other levered strategies enjoyed great success over the last 40 years?

In a recent visit with clients, I came up with a bit of imagery to convey my view of the effect of the prolonged decline in interest rates: At some airports, there's a moving walkway, and standing on it makes life easier for the weary traveler. But if rather than stand still on it, you walk at your normal pace, you move ahead rapidly. That's because your rate of travel over the ground is the sum of the speed at which you're walking <u>plus</u> the speed at which the walkway is moving.

That's what I think happened to investors over the last 40 years. They enjoyed the growth of the economy and the companies they invested in, as well as the resulting increase in the value of their ownership stakes. But in addition, they were on a moving walkway, carried along by declining interest rates. The results have been great, but I doubt many people fully understand where they came from. **It seems to me that a significant portion of all the money investors made over this period resulted from the tailwind generated by the massive drop in interest rates. I consider it nearly impossible to overstate the influence of declining rates over the last four decades.**

<u>The Recent Experience</u>

The period between the end of the Global Financial Crisis in late 2009 and the onset of the pandemic in early 2020 was marked by ultra-low interest rates, and the macroeconomic environment – and its effects – were highly unusual.

An all-time low in interest rates was reached when the Fed cut the fed funds rate to approximately zero in late 2008 in an effort to pull the economy out of the GFC. The low rates were accompanied by quantitative easing: purchases of bonds undertaken by the Fed to inject liquidity into the economy (and perhaps to keep investors from panicking). The effects were dramatic:

- The low rates and vast amounts of liquidity stimulated the economy and triggered explosive gains in the markets.
- Strong economic growth and lower interest costs added to corporate profits.
- Valuation parameters rose, as described above, lifting asset prices. Stocks increased non-stop for more than ten years, except for a handful of downdrafts that each lasted a few months. From a low of 667 in March 2009, the S&P 500 reached a high of 3,386 in February 2020, for a compound return of 16% per year.
- **The markets' strength encouraged investors to drop their crisis-inspired risk aversion and return to risk taking much sooner than expected. It also made FOMO – the fear of missing out – the prevalent emotion among investors. Buyers were eager to buy, and holders weren't motivated to sell.**
- Investors' revived desire to buy caused the capital markets to reopen, making it cheap and easy for companies to obtain financing. Lenders' eagerness to put money to work enabled borrowers to pay low interest rates under less-restrictive documentation that reduced lender protections.
- **The paltry yields on safe investments drove investors to buy riskier assets.**
- Thanks to economic growth and plentiful liquidity, there were few defaults and bankruptcies.
- The main exogenous influences were increasing globalization and the limited extent of armed conflict around the world. Both influences were clearly salutary.

As a result, in this period, the U.S. enjoyed its longest economic recovery in history (albeit also one of its slowest) and its longest bull market, exceeding ten years in both cases.

When the Covid-19 pandemic caused much of the world's economy to be shut down, the Fed dusted off the rescue plan that had taken months to formulate and implement during the GFC and put it into effect in a matter of weeks at a much larger scale than its earlier version. The U.S. government chipped in with loans and vast relief payments (on top of its customary deficit spending). The result in the period from March 2020 to the end of 2021 was a complete replay of the post-GFC developments enumerated above, including a quick economic bounce and an even quicker market recovery. (The S&P 500 rose from its low of 2,237 in March 2020 to 4,796 on the first day of 2022, up 114% in less than two years.)

For what felt like eons – from October 2012 to February 2020 – my standard presentation was titled "Investing in a Low Return World," because that's what our circumstances were. With the prospective returns on many asset classes – especially credit – at all-time lows, I enumerated the principal options available to investors:

- invest as you previously have, and accept that your returns will be lower than they used to be;
- reduce risk to prepare for a market correction, and accept a return that is lower still;
- go to cash and earn a return of zero, hoping the market will decline and thus offer higher returns (and do it soon); or
- ramp up your risk in pursuit of higher returns.

Each of these choices had serious flaws, and there's a good reason for that. **By definition, it's hard to achieve good returns dependably and safely in a low-return world.**

Regular readers of my memos know that my observations regarding the investment environment are primarily based on impressions and inferences rather than data. Thus, in recent meetings, I've been using the following list of properties to describe the period in question. (Think about whether you agree with this description. I'll return to it later.)

	2009 to 2021
Fed behavior	Highly stimulative
Inflation	Dormant
Economic outlook	Positive
Likelihood of distress	Minimal
Mood	Optimistic
Buyers	Eager
Holders	Complacent
Key worry	FOMO
Risk aversion	Absent
Credit window	Wide open
Financing	Plentiful
Interest rates	Lowest ever
Yield spreads	Modest
Prospective returns	Lowest ever

The overall period from 2009 through 2021 (with the exception of a few months in 2020) was one in which optimism prevailed among investors and worry was minimal. Low inflation allowed central bankers to maintain generous monetary policies. These were golden times for corporations and asset owners thanks to good economic growth, cheap and easily accessible capital, and freedom from distress. **This was an asset owner's market and a borrower's market. With the risk-free rate at zero, fear of loss absent, and people eager to make risky investments, it was a frustrating period for lenders and bargain hunters.**

On recent visits with clients, I've been describing Oaktree as having spent the years 2009 through 2019 "in the wilderness" given our focus on credit and our heavy emphasis on value investing and risk control. To illustrate, after raising our largest fund up to that time in 2007-08 and putting most of it to work very successfully in the wake of the Lehman Brothers bankruptcy, we thought it appropriate, given the investment environment, to cut the amount in half for its successor fund and halve it again for the fund after that. Oaktree's total assets under management grew relatively little during this period, and the returns on most of our closed-end funds, although fine, were moderate by our standards. **It felt like a long slog.**

That Was Then. This Is Now.

Of course, all of the above flipped in the last year or so. Most importantly, inflation began to rear its head in early 2021, when our emergence from isolation permitted too much money (savings amassed by people shut in at home, including distributions from massive Covid-19 relief programs) to chase too few goods and services (with supply hampered by the uneven restart of manufacturing and transportation). Because the Fed deemed the inflation "transitory," it continued its policies of low interest rates and quantitative easing, keeping money loose. These policies further stimulated demand (especially for homes) at a time when it didn't need stimulating.

Inflation worsened as 2021 wore on, and late in the year, the Fed acknowledged that it wasn't likely to be short-lived. Thus, the Fed started reducing its purchases of bonds in November and began raising interest rates in March 2022, kicking off one of the quickest rate-hiking cycles on record. The stock market, which had ignored inflation and rising interest rates for most of 2021, began to fall around year-end.

From there, events followed a predictable course. **As I wrote in the memo *On the Couch* (January 2016), whereas events in the real world fluctuate between "pretty good" and "not so hot," investor sentiment often careens from "flawless" to "hopeless" as events that were previously viewed as benign come to be interpreted as catastrophic.**

- Higher interest rates led to higher demanded returns. Thus, stocks that had seemed fairly valued when interest rates were minimal fell to lower p/e ratios that were commensurate with higher rates.
- Likewise, the massive increase in interest rates had its usual depressing effect on bond prices.
- Falling stock and bond prices caused FOMO to dry up and fear of loss to replace it.
- The markets' decline gathered steam, and the things that had done best in 2020 and 2021 (tech, software, SPACs, and cryptocurrency) now did the worst, further dampening psychology.
- Exogenous events have the ability to undercut the market's mood, especially in tougher times, and in 2022 the biggest such event was Russia's invasion of Ukraine.
- The Ukraine conflict reduced supplies of grain and oil & gas, adding to inflationary pressures.
- Since the tighter monetary policies were designed to slow the economy, investors focused on the difficulty the Fed would likely have achieving a soft landing, and thus the strong likelihood of a recession.

- The anticipated effect of that recession on earnings dampened investors' spirits. Thus, the fall of the S&P 500 over the first nine months of 2022 rivaled the greatest full-year declines of the last century. (It has now recovered a fair bit.)
- The expectation of a recession also increased the fear of rising debt defaults.
- New security issuance became difficult.
- Having committed to fund buyouts in a lower-interest-rate environment, banks found themselves with many billions of dollars of "hung" bridge loans unsaleable at par. These loans have saddled the banks with big losses.
- These hung loans forced banks to reduce the amounts they could commit to new deals, making it harder for buyers to finance acquisitions.

The progression of events described above caused pessimism to take over from optimism. The market characterized by easy money and upbeat borrowers and asset owners disappeared; now lenders and buyers held better cards. Credit investors became able to demand higher returns and better creditor protections. The list of candidates for distress – loans and bonds offering yield spreads of more than 1,000 basis points over Treasurys – grew from dozens to hundreds. Here's how the change in the environment looks to me:

	2009 to 2021	**Today**
Fed behavior	Highly stimulative	Tightening
Inflation	Dormant	40-year high
Economic outlook	Positive	Recession likely
Likelihood of distress	Minimal	Rising
Mood	Optimistic	Guarded
Buyers	Eager	Hesitant
Holders	Complacent	Uncertain
Key worry	FOMO	Investment losses
Risk aversion	Absent	Rising
Credit window	Wide open	Constricted
Financing	Plentiful	Scarce
Interest rates	Lowest ever	More normal
Yield spreads	Modest	Normal
Prospective returns	Lowest ever	More than ample

If the right-hand column accurately describes the new environment, as I believe it does, then we're witnessing a complete reversal of the conditions in the middle column, which prevailed in 2021 and late 2020, throughout the 2009-19 period, and for much of the last 40 years.

How has this change manifested itself in investment options? Here's one example: In the low-return world of just one year ago, high yield bonds offered yields of 4-5%. A lot of issuance was at yields in the 3s, and at least one new bond came to the market with a "handle" of 2. The usefulness of these bonds for institutions needing returns of 6 or 7% was quite limited. Today these securities yield roughly 8%, meaning even after allowing for some defaults, they're likely to deliver equity-like returns, sourced from contractual cash flows on public securities. Credit instruments of all kinds are potentially poised to deliver performance that can help investors accomplish their goals.

The Outlook

Inflation and interest rates are highly likely to remain the dominant considerations influencing the investment environment for the next several years. While history shows that no one can predict inflation, it seems likely to remain higher than what we became used to after the GFC, at least for a while. The course of interest rates will largely be determined by the Fed's progress in bringing inflation under control. If rates go much higher in that process, they're likely to come back down afterward, but no one can predict the timing or the extent of the decrease.

While everyone knows how little I think of macro forecasts, a number of clients have asked recently about my views regarding the future of interest rates. Thus, I'll provide a brief overview. (Oaktree's investment philosophy doesn't prohibit having opinions, just acting as if they're right.) In my view, the buyers who've driven the S&P 500's recent 10% rally from the October low have been motivated by their beliefs that (a) inflation is easing, (b) the Fed will soon pivot from restrictive policy back toward stimulative, (c) interest rates will return to lower levels, (d) a recession will be averted, or it will be modest and brief, and (e) the economy and markets will return to halcyon days.

In contrast, here's what I think:

- The underlying causes of today's inflation will probably abate as relief-swollen savings are spent and as supply catches up with demand.
- While some recent inflation readings have been encouraging in this regard, the labor market is still very tight, wages are rising, and the economy is growing strongly.
- Globalization is slowing or reversing. If this trend continues, we will lose its significant deflationary influence. (Importantly, consumer durables prices declined by 40% over the years 1995-2020, no doubt thanks to less-expensive imports. I estimate that this took 0.6% per year off the rate of inflation.)
- Before declaring victory on inflation, the Fed will need to be convinced not only that inflation has settled near the 2% target, but also that inflationary psychology has been extinguished. To accomplish this, the Fed will likely want to see a positive real fed funds rate – at present it's minus 2.2%.
- Thus, while the Fed appears likely to slow the pace of its interest rate increases, it's unlikely to return to stimulative policies any time soon.
- The Fed has to maintain credibility (or regain it after having claimed for too long that inflation was "transitory"). It can't appear to be inconstant by becoming stimulative too soon after having turned restrictive.
- The Fed faces the question of what to do about its balance sheet, which grew from $4 trillion to almost $9 trillion due to its purchases of bonds. Allowing its holdings of bonds to mature and roll off (or, somewhat less likely, making sales) would withdraw significant liquidity from the economy, restricting growth.
- Rather than be in a stimulative posture on a perpetual basis, one might imagine the Fed would prefer to normally maintain a "neutral interest rate," which is defined as neither stimulative nor restrictive. (I know I would.) Most recently – last summer – that rate was estimated at 2.5%.

- Similarly, although most of us believe the free market is the best allocator of economic resources, we haven't had a free market in money for well over a decade. The Fed might prefer to reduce its role in capital allocation by being less active in controlling rates and holding mortgage bonds.
- There must be risks associated with the Fed keeping interest rates stimulative on a long-term basis. Arguably, we've seen most recently that doing so can bring on inflation, though the inflation of the last two years can be attributed largely to one-off events related to the pandemic.
- The Fed would probably like to see normal interest rates high enough to provide it with room to cut if it needs to stimulate the economy in the future.
- People who came into the business world after 2008 – or veteran investors with short memories – might think of today's interest rates as elevated. But they're not in the longer sweep of history, meaning there's no obvious reason why they should be lower.

These are the reasons why I believe that the base interest rate over the next several years is more likely to average 2-4% (i.e., not far from where it is now) than 0-2%. Of course, there are counterarguments. But, for me, the bottom line is that highly stimulative rates are likely not in the cards for the next several years, barring a serious recession from which we need rescuing (and that would have ramifications of its own). **But I assure you Oaktree isn't going to bet money on that belief.**

What we do know is that inflation and interest rates are higher today than they've been for 40 and 13 years, respectively. No one knows how long the items in the right-hand column above will continue to accurately describe the environment. They'll be influenced by economic growth, inflation, and interest rates, as well as exogenous events, all of which are unpredictable. Regardless, I think things will generally be less rosy in the years immediately ahead:

- A recession in the next 12-18 months appears to be a foregone conclusion among economists and investors.
- That recession is likely to coincide with deterioration of corporate earnings and investor psychology.
- Credit market conditions for new financings seem unlikely to soon become as accommodative as they were in recent years.
- No one can foretell how high the debt default rate will rise or how long it'll stay there. It's worth noting in this context that the annual default rate on high yield bonds averaged 3.6% from 1978 through 2009, but an unusually low 2.1% under the "just-right" conditions that prevailed for the decade 2010-19. In fact, there was only one year in that decade in which defaults reached the historical average.
- **Lastly, there is a forecast I'm confident of: Interest rates aren't about to decline by another 2,000 basis points from here.**

As I've written many times about the economy and markets, we never know where we're going, but we ought to know where we are. The bottom line for me is that, in many ways, conditions at this moment are overwhelmingly different from – and mostly less favorable than – those of the post-GFC climate described above. These changes may be long-lasting, or they may wear off over time. But in my view, we're unlikely to quickly see the same optimism and ease that marked the post-GFC period.

We've gone from the low-return world of 2009-21 to a full-return world, and it may become more so in the near term. Investors can now potentially get solid returns from credit instruments, meaning they no longer have to rely as heavily on riskier investments to achieve their overall return targets. Lenders and bargain hunters face much better prospects in this changed environment than

they did in 2009-21. And importantly, if you grant that the environment is and may continue to be very different from what it was over the last 13 years – and most of the last 40 years – it should follow that the investment strategies that worked best over those periods may not be the ones that outperform in the years ahead.

That's the sea change I'm talking about.

December 13, 2022

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Memo to: Oaktree Clients

From: Howard Marks

Re: Lessons from Silicon Valley Bank

This isn't going to be another history of the meltdown of Silicon Valley Bank. Dozens of those have appeared in my inbox over the past month, as I'm sure they have in yours. Thus, rather than merely recount the developments, I'm going to discuss their significance.

My sense is that the significance of the failure of SVB (and Signature Bank) is less that it portends additional bank failures and more that it may amplify preexisting wariness among investors and lenders, leading to further credit tightening and additional pain across a range of industries and sectors.

One-off or a Harbinger of Things to Come?

A number of things about SVB made it somewhat of a special case – which means it probably won't turn out to be the first of many:

- The bank's business was heavily concentrated in a single sector – venture capital-backed startups in tech and healthcare – and a single region – Northern California. Many regional banks' businesses are similarly concentrated, but not usually in sectors and regions that are both highly volatile.
- The boom in its sector and region caused SVB's business to grow very rapidly.
- In recent years, startups were a major destination for investors' cash, a good deal of which they deposited at SVB. This caused SVB's deposits to triple, from $62 billion at the end of 2019 to $189 billion at the end of 2021.
- For the same reason, many of SVB's clients had so much capital that they had little need to borrow. As deposits piled up at SVB, there wasn't offsetting demand for loans. Few other banks have customers with similar cash inflows and consequently so little need to borrow money.
- Because SVB had few traditional banking uses for the cash that piled up, it instead invested $91 billion in Treasury bonds and U.S. government agency mortgage-backed securities between 2020 and 2021. This brought SVB's investments to roughly half its total assets. (At the average bank, that figure is about one-quarter.)
- Presumably to maximize yield – and thus the bank's earnings – in what was a low-return environment, SVB bought securities with long-dated maturities. SVB designated these securities as "hold to maturity" (HTM) assets, meaning they wouldn't be marked to market on the bank's balance sheet since it had no intention of selling them.
- When the Federal Reserve embarked on its program of interest rate increases last year, bond prices fell rapidly, and, of course, the longer the tenor of the bonds, the greater the decline in value. In short order, the market value of SVB's bond holdings was down $21 billion.
- Word of the bank's losses caused depositors to start withdrawing their money. To meet the withdrawals, SVB had to sell bonds. Consequently, the bonds could no longer be considered HTM. Instead, they had to be categorized as "available for sale" (AFS), meaning (a) the bonds were marked down on SVB's financial statements and (b) actual sales caused the losses to be crystalized.

- The recognized losses helped hasten the spread of negative rumors throughout the tight-knit venture capital community, which led to further withdrawals. An unusually large percentage of SVB's deposits – 94% – exceeded $250,000 and thus weren't fully insured by the FDIC. This meant they were more "institutional" than "retail." Additionally, SVB's customers were highly interconnected: They had many backers in common, lived and worked near each other, and could exchange information almost instantaneously through social media.

The sum of the above rendered SVB particularly vulnerable to a bank run if adverse circumstances developed – and they did. However, many of the above factors were peculiar to SVB. Thus, I don't think SVB's failure suggests problems are widespread in the U.S. banking system.

What Did SVB Have in Common with Other Banks?

I talked above about some things that distinguished SVB from other banks. But it's as important to consider the elements they shared:

- Asset/liability mismatch – **Financial mismatches are dangerous, and banks are built on them.** Deposits are banks' primary source of funds, and while some have longer terms, most can be withdrawn on any day, without prior notice. On the other hand, making loans represents banks' main use of funds, and most loans have lives ranging from one year (commercial loans) up to 10-30 years (mortgages). So, while most depositors can demand their money back at any time, (a) no banks keep enough cash on hand to pay back all their depositors, (b) their main assets don't pay down in a short timeframe, and (c) if they need cash, it can take them a long time to sell loans – especially if they want a price close to par. Maintaining solvency requires bank managements to be aware of the riskiness of the assets they acquire, among other things. But liquidity is a more transient quality. **By definition, no bank can have enough liquidity to meet its needs if enough depositors ask for their money all at once.** Managing these issues is a serious task, since it's a bank's job to borrow short (from its depositors) and lend long.

  This mismatch, like most other mismatches, is encouraged by the upward slope of the typical yield curve. If you want to borrow, you'll find the lowest interest rates at the "short end" of the curve. Thus, you minimize your costs by borrowing for a day or a month . . . **but you expose yourself to the risk of rising interest expense, since you haven't fixed your rate for long.** Similarly, if you want to lend (or invest in bonds), you maximize your interest income by lending long . . . **but that subjects you to the risk of capital losses if interest rates rise**. If you follow the yield curve's dictates, you'll always borrow short and lend long, exposing you to the possibility of an SVB-type mismatch.

- High leverage – Banks operate with skinny returns on assets. They pay depositors (or the Fed) a low rate of interest to borrow the funds they need to operate, and they lend or invest those funds at slightly higher rates, earning a modest spread. But they literally make it up on volume. They employ heavy leverage, meaning they can do a lot of business based on little equity capital, thereby translating a low return on assets into a high return on equity. However, having a high ratio of total assets to equity capital means a modest decline in asset prices can wipe out a bank's equity, rendering it insolvent. **There's no source of meltdown – in any sector – as potentially toxic as the combination of high leverage and an asset/liability mismatch.** Banks have them both.

- Reliance on trust – Since depositors put money in banks in pursuit of safety and liquidity and, in exchange, accept a low return, faith in banks' ability to meet withdrawals is obviously paramount. Depositors ostensibly can get liquidity, safekeeping, and low interest from any bank – that is, one bank's offering is essentially undifferentiated from those of others. Thus, most depositors are perfectly willing to change banks if given the slightest reason, and there's no offsetting reason for them to leave their money on deposit if a bank's safety is questioned.

You may be familiar with one of my favorite sayings: "Never forget the six-foot-tall person who drowned crossing the stream that was five feet deep on average." **Surviving on average is a useless concept; you have to be able to survive all the time, including – no, especially – in bad times.** Borrowing short to invest long powerfully threatens that ability. Being highly levered is another reason why, metaphorically, tall people sometimes drown in streams that are shallow on average. And for financial institutions, customers' loss of confidence is a third.

The bottom line is that banks are, essentially, highly levered fixed income investors. Any long-term, fixed-rate loans or bonds they own (which for most banks aren't a large percentage of total assets) are subject to declines in economic value in a rising-interest-rate environment. Banks don't have to recognize price declines on assets they intend to hold to maturity, but any bank that is forced to sell those assets to meet withdrawals would have to show the declines on its financial statements.

Looked at this way, retaining depositors' trust is an absolutely essential ingredient in a bank's activities, and that means assets, liabilities, liquidity, and capital have to be skillfully managed. In SVB's case, its equity went up in smoke when rising interest rates reduced the value of a good part of its assets.

In that vein, I'm going to share a personal anecdote. When our son, Andrew, went off to college in 2005, Nancy and I concluded it would be great to live outside the United States for a while, something neither of us had ever done. We chose to live in the UK for four months of the year, during which I worked in Oaktree's London office. To generate income to cover our living expenses, we moved cash to a UK bank and asked that it be deposited in CDs at several building societies (what we in the U.S. call savings & loans). One of those was Northern Rock. In September 2007, as the financial crisis was brewing, Northern Rock had trouble securing the financing it needed in the wholesale funding market on which it traditionally had depended. That prompted depositors to queue up to close their accounts.

I called my banker on a Friday afternoon to ask whether I could move my funds elsewhere, and he told me there would be a 2% penalty for early withdrawal. It took me about one second to say, "please move those funds first thing Monday morning." A 2% penalty sounded like peanuts relative to risking my entire principal at Northern Rock. Now imagine the thinking of SVB depositors who could withdraw their money without any penalty. (As it happens, the UK government guaranteed Northern Rock's deposits over the weekend in question, eliminating the need to move the funds. But that was my closest brush with a bank failure.)

Another new trend that has added to banks' precariousness is the emergence of digital communications, including social media. Sixteen years ago, it took days for Northern Rock's depositors to become aware of its difficulties. And when they decided to move their money, they had to go to their branch during banking hours (what a quaint notion), queue up, and submit a withdrawal request. In SVB's case, word of the bond losses traveled quickly, through unusually interconnected depositors who had the ability to request withdrawals online. As a result, more than one-third of the bank's deposits departed in a single day. All banks have to contend with digital communication and online withdrawals these days, but SVB's depositors were particularly high flight risks, given the bank's region and the nature of its clientele.

About twenty years ago, my partner Sheldon Stone shared an interesting parable: Imagine you're on a boat crossing Lake Erie. The captain comes on the loudspeaker and says, "Everyone run to the left side of the boat." A minute later he says, "Everyone run to the right side." And a minute after that he says, "Run back to the left." It would make for an unusually rocky crossing. Today the internet and social media are the loudspeaker, which almost anyone can take over, disseminating any message they choose. This "digital herding," as Gillian Tett of *The Financial Times* has labeled it, can have a huge impact in many fields, particularly those that run on information and trust.

Was SVB's Collapse Inevitable?

To close the loop, I'm going to recap the interrelated factors that caused SVB to fail:

- If the bank had made more loans relative to the size of its deposit base, it wouldn't have bought as many potentially volatile bonds.
- If the bonds the bank bought hadn't had such long maturities, it wouldn't have been as exposed to price declines.
- If the Fed hadn't raised interest rates as much as it did, the bonds wouldn't have lost so much value.
- If the depositors hadn't exited en masse, the bank wouldn't have had to sell bonds and realize the losses.

You wouldn't think a portfolio consisting of bank loans and high-quality Treasury and mortgage-backed bonds could be vulnerable to a meltdown that would render a bank insolvent. But the scale of SVB's bond investments, the length of the maturities, and the extent of the Fed's interest rate hikes put SVB at risk, and the rapidity of the withdrawals caused the problem to run far ahead of the solutions.

When looking at SVB's demise, the decision-making behind its bond purchases stands out as particularly flawed and probably the primary cause of the bank's failure. According to public reports, SVB management "made a bet" that interest rates would hold steady or fall. While that expectation is implicit in its actions, I find it hard to believe it was a conscious, considered decision, as opposed to an example of mindlessly chasing yield, perhaps abetted by wishful thinking. The bond purchases took place in 2020 and 2021. In that two-year period, the yield on the 30-year Treasury ranged between 0.99% and 2.45%. How could anyone have thought rates that low were more likely to hold steady or fall than rise? Determining how to move forward is always challenging in economics and investing. However, when the Fed and Treasury flooded the economy with cash in 2020 and inflation began to rise in 2021, **the one thing that should have been obvious was that there was no good reason to hold long-dated bonds at pitifully low yields, which presented profound risk and miniscule potential for return.**

Comparisons to the GFC

SVB's failure – along with the collapse of Signature Bank, the rescue of First Republic Bank, and Credit Suisse's forced sale to UBS – roiled markets in March. This resulted from fear of bank failure contagion along the lines of what we saw during the Global Financial Crisis of 2007-08, when Bear Stearns, Merrill Lynch, Lehman Brothers, Wachovia Bank, Washington Mutual, and AIG either melted down or required rescues. There were times in that span, particularly in the last four months of 2008, when investors were forced to contemplate the possibility of an unstoppable series of failures that could have endangered the entire financial system. Nobody wants to face that again.

While I want to state clearly that I'm not an expert on banks or their regulation, I think the similarities between 2008 and 2023 are limited to the mere fact that, in both instances, problems existed at a few financial institutions. I find the common elements mostly superficial. What follows are the differences.

By far most importantly, the GFC occurred for the simple reason that investors and financial institutions experienced temporary insanity with respect to residential mortgages. They:

- accepted unquestioningly that mortgages' low-default history could be extrapolated;
- forced massive amounts of money into the mortgage market;
- loaned lots of it to subprime borrowers who couldn't or wouldn't document income or assets;
- built tranched and levered mortgage-backed securities using subprime mortgages; and
- in many cases, invested their own capital in the riskiest tranches of the RMBS to enable the formation process to be repeated.

These parties ignored the possibility that excessive faith in mortgages – and the resultant lowering of lending standards – could precipitate massive numbers of mortgage defaults. Further, they ignored the fragility of the structured securities built out of those mortgages. Investors, bankers, and rating agencies (which awarded AAA ratings to thousands of RMBS issues) naively trusted that people who were willing to pay extra interest to obtain mortgages without disclosing their financial condition would repay those mortgages, even if the prices of the homes they bought fell. This led them to conclude that mortgage defaults wouldn't be sufficient to jeopardize the mortgage-backed securities' viability. Subprime mortgages were totally lacking in substance, yet many of the world's leading financial institutions were happy to make those loans and invest in securities built out of them.

Looking at the current situation, I can't think of anything that's highly analogous to the subprime mortgages at the heart of the GFC. There are things here or there that have been over-hyped or are short on substance – some people will point to SPACs or cryptocurrencies – but they're not as massive in scale, perhaps not as lacking in substance, and certainly not held on the balance sheets of America's key financial institutions in amounts sufficient to endanger our financial system. **Indeed, I think it's safe to say the most glaring market excesses were corrected in 2022 and aren't hanging over us now. (However, for a caveat, please see this memo's last few paragraphs.)**

In addition, whereas the list of institutions that disappeared during the GFC included some that clearly were systemically important, I don't think that can be said of SVB. I doubt our financial system was highly reliant on promises made by SVB and thus subject to extensive counterparty risk. The GFC affected some truly large banks – household names – and most people believed it was on the way to jeopardizing even bigger ones before the government stepped in. There's no reason to think the failure of SVB poses the same risk.

Finally, it should be borne in mind that even though huge banks appeared to be endangered in 2008, **the Fed and other economic policymakers were able to come up with rescue plans** (for the institutions and for the economy), **and they worked!** In that vein, it's worth noting that the Fed's response to SVB's problems included (a) guaranteeing all SVB deposits, (b) making additional liquidity available to banks, (c) injecting extensive liquidity into the economy, and (d) letting its balance sheet grow, even though it's been in the process of winding it down from its post-pandemic high. Thus, I find it hard to believe that SVB or the like can set off a chain reaction sufficient to trigger an irreversible financial crisis.

On the subject of the problem's scale, I want to mention a new pet peeve of mine. Increasingly, we hear the media say things like, "this was the best month in the stock market since 2020" or "we saw more new daily lows today than on any day since October." The media like this kind of dramatic-sounding comparison, and the latest is that "SVB is the biggest bank to fail since the GFC." But these comparisons don't always mean much. In the case of SVB, it should be noted that, while this is the second-biggest bank failure in history, SVB was only two-thirds the size of Washington Mutual, the biggest. Further, since the financial sector has expanded meaningfully in the last 15 years, WaMu's $307 billion of assets in 2008 were much more significant than SVB's $209 billion today.

A Word on Regulation

In March 2011, in the aftermath of the GFC, I published a memo called *On Regulation*. Its basic thrust was that financial regulation is highly cyclical. Crashes, meltdowns, and widespread misbehavior bring on calls for increased regulation. They also make increased regulation palatable to most parties. But when the new regulations succeed – and thus appear to make the financial environment safer and better functioning – free marketeers and people with vested interests typically start to argue that such strong regulation is no longer necessary and that it restricts the financial system's effectiveness. For example, in response to the Great Crash of 1929, massive new regulations were enacted between 1930 and 1940 to constrain conduct in the wild, wild west of Wall Street. But by the 1990s, the pain of the Crash was long forgotten, and belief in the efficacy of the free market was riding high. As a result, multiple regulations were dismantled, enabling conduct that contributed to very painful experiences in the GFC.

The GFC, in turn, inspired another round of regulation. One of the governing principles was that financial institutions that are too big to fail – and thus will, by necessity, be bailed out if threatened – shouldn't be permitted to engage in risky activities, as this creates a situation where "heads, the shareholders and management win; tails, the taxpayers lose." That proposition seems reasonable on its face and was implemented via the Dodd-Frank Act and its Volcker Rule. In general, bank regulation was significantly tightened.

As time passed, the normal pushback against regulation emerged. The aspect that's most relevant here is the regulatory threshold. Following the GFC, all banks with assets above $50 billion were subject to the strictest standards. But in 2018, regulators were convinced to raise that figure to $250 billion (thanks in part to the lobbying of SVB's chief executive officer). As a result, SVB – with assets around $50 billion at the time the threshold was raised – faced a looser regulatory regime. This helped it expand massively – until it failed in a matter of days.

Nevertheless, thanks to the post-GFC rules, the major U.S. banks today are well capitalized and have significant liquidity and healthy balance sheets. This makes it less likely that we'll see a GFC-type round of bank failures. I've heard it argued that current regulations and the resultant financial condition of banks aren't robust enough, but I believe most banks – and especially the majors – are much stronger than they were before and during the GFC and typically much stronger than SVB.

Interestingly, Canada, Australia, and Britain function very well with far fewer banks than the U.S. Canada, for example, has $2 trillion of GDP and just 34 domestic banks (17 per $1 trillion of GDP), and it seems to get by. In contrast, in 2021, the U.S. had 4,236 FDIC-insured commercial banks for its $20 trillion of GDP, or 212 banks per $1 trillion. Could regulators do a better job if there were fewer banks to monitor? We'll see what happens to the number of U.S. banks if big ones absorb smaller ones and deposits become concentrated in the bigger ones. But given the role of private parties and their money in our system of government, I don't expect to see a major change.

Moral Hazard

One problem with government solutions of any kind – like the so-called "Greenspan put" – is the possibility that they'll generate moral hazard. That is, players will conclude that they'll be rescued if they make a mistake. This suggests they can freely engage in high-risk, high-return behavior; if it works, they'll get rich, but if it fails, they'll be bailed out. People sometimes refer to this as "privatizing profits and socializing losses."

On March 9, when SVB was hanging by a thread while experiencing massive withdrawals, people started talking about a possible government guarantee of all deposits. One of the arguments against such a bailout was that it would create moral hazard. If people know they'll be protected from losses, they'll have no reason to examine the solidity of a bank before depositing money, meaning the diligence function won't be performed. Consequently, poorly run, poorly capitalized banks will be permitted to stay in business and grow.

But we simply cannot expect depositors to perform that function. Since banks' operations are characterized by mismatched assets/liabilities and a dependence on depositors' trust, it's terribly hard to assess their financial health from the outside (maybe sometimes from the inside, too, since SVB succumbed to what in retrospect seem to have been obvious managerial mistakes). In the 28 years that Oaktree has been in business, we've invested in relatively few deposit-taking financial institutions. Other than in cases where we've become insiders, we've generally avoided investing in banks because their complex, often impenetrable financial disclosures and reliance on trust make them harder to evaluate than we like.

Few people are capable of studying banks' financial statements and determining whether they'll remain solvent and liquid. **Expecting depositors to do so could cause banking to grind to a halt.** That's why deposit insurance was introduced during the Great Depression. For the same reason, the government's decision to fully guarantee SVB's deposits was quite appropriate.

Notably, however, management and shareholders weren't bailed out; rather, in today's parlance, they were "bailed in," or left with their losses. We can hope their losses will encourage other investors and bank managers to apply greater prudence in their future decision-making.

AT1s

While not at all related, SVB's failure gives me a chance to discuss another topic involving financial institutions that's recently been in the news: Additional Tier 1 bonds, or AT1s. On the heels of the GFC, European regulators required banks to raise new equity capital ("tier 1 capital") and delever. However, given the risks surrounding the banks, potential providers of capital demanded inducements. With AT1s, these came in the form of bond-like yields, a promise of repayment at maturity, and debtholder status. So far, so good.

In UBS's recent takeover/rescue of Credit Suisse, FINMA, the Swiss bank regulator, determined that (a) shareholders would receive modest compensation and (b) the holders of the $17 billion of AT1s would get nothing. There was an immediate outcry, along with threats of litigation.

Although AT1s are clothed as debt securities, it seems FINMA had the power to alter the AT1s' priority relative to the shareholders and even eliminate their value. In this case, they chose to put the AT1s behind the shareholders, wiping out investors who thought they were creditors. As *Bloomberg* noted on March 23, this shouldn't have come as a surprise:

> A prospectus for the Credit Suisse AT1s highlights from the very first page the possibility of a wipeout when there is what's known as a writedown event. In this scenario, interest on the notes would stop accruing and the full outstanding amount of the bonds would be automatically and permanently written down to zero. Finma has the power to decide that a type of writedown event known as a "viability event" has occurred if a bank's efforts to improve capital adequacy are "inadequate or unfeasible," or if there is "extraordinary public support" to avoid a bankruptcy, insolvency or halt to regular business.

Bloomberg's Matt Levine explained how this worked in Credit Suisse's case:

> If the bank's common equity tier 1 capital ratio – a measure of its regulatory capital – falls below 7%, then the AT1 is *written down to zero:* It never needs to be paid back; it just goes away completely. . . .
>
> **These securities are, basically, a trick.** To *investors*, they seem like bonds: They pay interest, get paid back in five years, feel pretty safe. To *regulators,* they seem like equity: If the bank runs into trouble, it can raise capital by zeroing the AT1s**. If investors think they are bonds and regulators think they are equity, somebody is wrong. The investors are wrong.**
>
> In particular, investors seem to think that AT1s are *senior* to equity, and that the common stock needs to go to zero before the AT1s suffer any losses. But this is not quite right. You can tell because **the whole point of the AT1s is that they go to zero if the common equity tier 1 capital ratio falls below 7%.** (*Bloomberg Opinion; Money Stuff*, March 20, 2023. Bolding added.)

Were the investors misled? To me, the answer is no. In this regard, let's consider the way the prospectus for one such Credit Suisse issuance – "a $2 billion US dollar 7.5% AT1 issued in 2018" – was labeled (per Matt Levine): "7.500 per cent. Perpetual Tier 1 Contingent Write-down Capital Notes." There shouldn't have been much doubt about their riskiness when "write-down capital notes" was in the title.

I once wrote of Bernie Madoff that you can say you did thorough due diligence or you can say he passed the test, but you can't say you did thorough due diligence and he passed the test. Likewise, in the case of Credit Suisse's AT1s, you can say you read and understood the prospectus, or you can say you thought they were like ordinary debt securities, but you can't say both.

Maybe there's a third path; maybe you could say "I knew the regulators had the power to zero me out, but I didn't think they ever would." **It seems to me that if people can take value from you legally, and especially if doing so isn't unambiguously immoral, you shouldn't be surprised if they do.** Holders of high yield bonds have for many years dealt with an analogous phenomenon called "event risk," which refers to actions undertaken by company management for the purpose of transferring value from bondholders to stockholders. In the case of Credit Suisse, the regulators likely gained the cooperation of shareholders by paying them a few francs per share while wiping out the AT1s. Under the circumstances, that shouldn't have come as a complete surprise. **It's all part of protecting banks, which – as noted above – are risky by nature.**

Psychological Ramifications of the SVB Collapse

As I previously mentioned, I don't view SVB, Signature Bank, First Republic, and Credit Suisse as having been connected other than by the fact that they were in the same general line of work. That did give them one thing in common: Since they're all financial institutions, events involving them can broadly impact depositors' and investors' confidence (or lack thereof). People seem to have trouble dealing with multiple problems at once, and the near-simultaneous challenges at four banks caused people to string them all together like beads, crafting a narrative that included a potential systemic meltdown.

While they don't seem to me to be connected in tangible ways, the four banks' recent crises certainly had the power to shake things up. And when participants in the economy or market are shaken up, the implications can be serious. As President Franklin D. Roosevelt said in his 1933 inaugural address during the Great Depression, **"the only thing we have to fear is fear itself."** Things don't have to be connected physically or even economically. In the markets, a series of scary events can have a very powerful impact.

The credit crises during which my partners and I have invested over the last 38 years generally have resulted from some combination of (a) negative economic developments, (b) excesses in the markets, (c) adverse exogenous events, and (d) rising fear among investors and finance industry professionals. The failures of SVB and the other banks likely aren't enough to bring on a credit crisis, but they could contribute to one. As a result, it seems inescapable that some financial institutions will reduce the amount of credit they make available, causing some borrowers to be left out. In particular, SVB's failure could mean the startup world will have a tougher time getting financing in the months ahead. Regional and community banks are likely to undergo increased scrutiny and experience deposit flight as cash flows to money market funds and larger banks perceived to be safer. Their importance as the main financers of real estate makes it likely that the going will get tougher for property owners and developers, just as office buildings, brick-and-mortar retail, and perhaps even multifamily are coming under pressure in many regions.

Combine developments like these with the reality that (a) interest rates are no longer declining or near zero; (b) the Fed can't be as accommodative as it was in the last few crises, because of today's elevated inflation; and (c) negative developments are popping up in portfolios, and I think the case made in my previous memo, *Sea Change* (December 2022), has been bolstered. The easy-money environment of the last few years has been blamed for – among other things – the difficulties at SVB and its peers. Their failure is likely to bring stricter scrutiny to banking, meaning things are unlikely to be as easy in the period ahead. And to paraphrase Warren Buffett, now that the tide has gone out a bit, we've caught a glimpse of some who were swimming naked near shore. The remaining questions are, how many more are out there, and will the tide go out far enough to expose them?

When investors think things are flawless, optimism rides high and good buys can be hard to find. But when psychology swings in the direction of hopelessness, it becomes reasonable to believe that bargain hunters and providers of capital will be holding the better cards and will have opportunities for better returns. We consider the meltdown of SVB an early step in that direction.

* * *

While I don't foresee widespread contagion – either psychological or financial – arising from the SVB failure alone, I can't end a memo on U.S. banks without mentioning one of the biggest worries they face today: the possibility of problems stemming from loans against commercial real estate ("CRE"), especially office buildings.

The following factors are influencing the CRE sector today:

- Interest rates are up substantially. While some borrowers benefit from having fixed interest rates, roughly 40% of all CRE mortgages will need to be refinanced by the end of 2025, and in the case of fixed-rate loans, presumably at higher rates.
- Higher interest rates call for higher demanded capitalization rates (the ratio of a property's net operating income to its price), which will cause most real estate prices to fall.
- The possibility of a recession bodes ill for rental rates and occupancy, and thus for landlords' income.
- Credit is likely to be generally less available in the coming year or so.
- The concept of people occupying desks in office buildings five days a week is in question, threatening landlords' underlying business model. While workers may spend more time in the office in the future, no one knows what occupancy levels lenders will assume in their refinancing calculations.

Total U.S. bank assets exceed $23 trillion. Banks collectively are the biggest real estate lenders, and while we only have rough ranges for the data, they're estimated to hold about 40% of the $4.5 trillion of CRE mortgages outstanding, or around $1.8 trillion at face value. Based on these estimates, CRE loans represent approximately 8-9% of the average bank's assets, a percentage that is significant but not overwhelming. (Total exposure to CRE may be higher, however, as any investments in commercial mortgage-backed securities have to be considered in addition to banks' holdings of direct CRE loans.)

However, CRE loans aren't spread evenly among banks: Some banks concentrate on parts of the country where real estate markets were "hotter" and thus could see bigger percentage declines; some loaned against lower-quality properties, which is where the biggest problems are likely to show up; some provided mortgages at higher loan-to-value ratios; and some have a higher percentage of their assets in CRE loans. To this latter point, a recent report from Bank of America indicates that average CRE loan exposure is just 4.5% of total assets at banks with more than $250 billion of assets, while it's 11.4% at banks with less than $250 billion of assets.

Since banks are so highly levered, with collective equity capital of just $2.2 trillion (roughly 9% of total assets), the estimated amount the average bank has in CRE loans is equal to approximately 100% of its capital. Thus, losses on CRE mortgages in the average loan book could wipe out an equivalent percentage of the average bank's capital, leaving the bank undercapitalized. As the BofA report notes, the average large bank has 50% of its risk-based capital in CRE loans, while for smaller banks that figure is 167%.

Notable defaults on office building mortgages and other CRE loans are highly likely to occur. Some already have. But that doesn't necessarily mean the banks involved will suffer losses. If loans were made at reasonable LTV ratios, there could be enough owners' equity beneath each mortgage to absorb losses before the banks' loans are jeopardized. Further, mortgage defaults generally don't signal the end of the story, but rather the beginning of negotiations between lenders and landlords. In many cases, the result is likely to be extension of the loan on restructured terms.

No one knows whether banks will suffer losses on their commercial real estate loans, or what the magnitude will be. But we're very likely to see mortgage defaults in the headlines, and at a minimum, this may spook lenders, throw sand into the gears of the financing and refinancing processes, and further contribute to a sense of heightened risk. Developments along these lines certainly have the potential to add to whatever additional distress materializes in the months ahead.

April 17, 2023

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Memo to: Oaktree Clients

From: Howard Marks

Re: Taking the Temperature

In preparation for my interview for "Lunch with the FT" last fall, I sent the reporter, Harriet Agnew, five memos I had written between 2000 and 2020 that contained market calls. How were they chosen? First, I felt the memos accurately conveyed my thinking at the key turning points in that 20-year period. And second, my calls turned out to be right.

Five Calls

I've written before about the time in 2017 when I was working on my book *Mastering the Market Cycle* and batting ideas back and forth with my son Andrew. I said, "You know, looking back, I think my market calls have been about right." **His response was dead on target as usual: "Yeah, Dad, that's because you did it five times in 50 years." It struck me like an epiphany: He was 100% correct**. In those five instances – around the publication of the respective memos – the markets were either crazily elevated or massively depressed, and as a result, I was able to recommend becoming more defensive or more aggressive with a good chance of being right. (Before I go further, let me make it clear that while hindsight shows that the logic behind those calls was correct, that doesn't mean I made them without great trepidation.)

To illustrate how one might approach making market calls, I'm going to briefly summarize what led me to make those five calls. (I'm not going to go into detail, since the contemporaneous memos I cite in each section will supply more than enough for those who're interested.) As you read the description of each event, look closely at how the forces that contributed to – and resulted from – each episode led to the next one. You'll be able to appreciate why I've long stressed the role of causality in market cycles.

January 2000

In the fall of 1999, against the backdrop of the massive gains being achieved in tech, media, and telecom stocks, I read Edward Chancellor's excellent book *Devil Take the Hindmost*. I was struck by the similarities between the TMT boom and the historical bubbles that are the subject of that book. The lure of easy profits, the willingness to leave one's day job to cash in, the ability to invest blithely in money-losing companies whose business models one can't explain – all these felt like themes that had rhymed over the course of financial history, leading to bubbles and their painful bursting. And all of them were visible in investor behavior as 1999 came to an end.

While I wasn't involved directly in equities and Oaktree's investments had little if any exposure to technology at the time, I observed many market narratives that I thought were too good to be true. Thus, I said so in the memo *bubble.com*, which was published as 2000 began. The memo described how tech investors were buying the stocks of young companies at astronomical prices set in many cases as a multiple of current revenues, as the companies often had no profits. In fact, many had no revenues, in which case the price was based on little more than a concept and hope. I define a bubble as an irrationally elevated opinion of an asset or sector, and the TMT craze of the late 1990s exemplified this definition. Thus, I wrote as follows:

> In short, I find the evidence of an overheated, speculative market in technology, Internet and telecommunications stocks overwhelming, as are the similarities to past manias. . . .
>
> To say technology, Internet and telecommunications stocks are too high and about to decline is comparable today to standing in front of a freight train. To say they have benefited from a boom of colossal proportions and should be examined very skeptically is something I feel I owe you.

In my opinion, the TMT bubble burst in early 2000 for no reason other than that stock prices had become unsustainably high. The Standard & Poor's 500 Index fell by 46% from its 2000 high to the low in 2002, and the tech-heavy NASDAQ Composite declined by 80% during this period. Many tech stocks lost much more, and many young companies in fields such as e-commerce ended up becoming worthless. And the word "bubble" became part of everyday speech for a new generation of investors.

<u>Late 2004 to Mid-2007</u>

The aftermath of the TMT bubble led to an environment in the mid-aughts that felt to me like a slow-developing trainwreck, with an emphasis on "slow-developing." I started complaining too soon . . . or maybe my timing was reasonable but the negative consequences just took longer to develop than they should have.

In summary, the Federal Reserve was engaging in accommodative monetary policy – taking the fed funds rate to new lows – to battle the potential ramifications of the TMT bubble's bursting. Thus, in my memo *Risk and Return Today* from late 2004, I observed that (a) prospective returns on most asset classes were unusually low and (b) risk-seeking on the part of investors looking to improve on those low returns had led them to embrace higher-risk and "alternative" investments.

I identified some of these alternatives in the memo *There They Go Again* (May 2005), spending most of my time discussing residential real estate, as that was where investors were embracing the most glaring fallacy: **the belief that home prices only go up.** I also discussed the tendency of investors to (a) ignore the lessons of past cycles, (b) fall for new developments, and (c) pile into risky investments, guided by time-honored platitudes such as "it's different this time," "higher risk means higher returns," or "if it stops working, I'll just get out." Many of these logical errors were being committed by investors in the housing market.

The driving force behind Oaktree's behavior in that period wasn't any of the above. Rather, it was the fact that my Oaktree co-founder Bruce Karsh and I were spending much of each day trudging to each other's offices to complain about the crazy deals – characterized by low returns, high risk for investors, and a lot of optionality for issuers – that were easily being brought to market. **"If deals like this can get done," we agreed, "there's something wrong with the market."** Few people, we thought, were demonstrating prudence, discipline, value consciousness, or the ability to resist the fear of missing out. Investors are supposed to act as disciplinarians, preventing undeserving securities from being issued, but in those days, they weren't performing that function. This signaled a worrisome state of affairs.

These observations – along with an awareness of the generally high prices and low prospective returns that prevailed at the time – convinced us to dramatically increase our usual emphasis on defensiveness. In response, we sold off large amounts of assets, liquidated large funds, organized small funds (or none at all in certain strategies), and significantly raised the bar against which potential new investments would be evaluated.

In July 2007, I published the memo *It's All Good*, in which I was more emphatic (and had better timing):

> Where do we stand in the cycle? In my opinion, there's little mystery. I see low levels of skepticism, fear and risk aversion. Most people are willing to undertake risky investments, often because the promised returns from traditional, safe investments seem so meager. This is true even though the lack of interest in safe investments and the acceptance of risky investments have rendered the slope of the risk/return line quite flat. Risk premiums are generally the skimpiest I've ever seen, but few people are responding by refusing to accept incremental risk. . . .

Eight months after I wrote *It's All Good*, Bear Stearns melted down under the weight of funds that had invested in subprime mortgages. Then, in mid-September we saw – in rapid succession – the rescue of Merrill Lynch by Bank of America, the bankruptcy of Lehman Brothers, and the bailout of AIG. The S&P 500 Index fell to a low of 735 in February 2009, down 53% from its high of 1,549 reached in 2007 (and down 39% from its level around the time I put out the way-too-early *Risk and Return Today).*

Importantly, Oaktree had essentially no involvement with subprime mortgages or mortgage-backed securities. Moreover, those assets were traded in a relatively remote corner of the investment world, and we had little appreciation for what was taking place there. **In other words, our cautious conclusions weren't reached on the basis of subject-matter expertise but rather on an unusually good example of what I call "taking the temperature of the market"** (see pages 9-10).

Late 2008

The world seemed relatively tranquil as September 2008 began, but then Lehman Brothers' bankruptcy filing, mentioned above, took place mid-month. The markets promptly fell apart, based on an apocalyptic view that Lehman's failure was part of a logical progression that had started when Bear Stearns ceased to exist as an independent entity and could eventually lead to a meltdown of the worldwide financial system. Complacency gave way to panic, and the Global Financial Crisis – in capital letters – was upon us.

Anticipating that the reckless behavior we were witnessing (see the previous section) would ultimately create significant buying opportunities for our distressed debt strategy, Oaktree organized an $11 billion "reserve fund" for distressed debt between January 2007 and March 2008. The fund was created to give us capital to invest if things reached crisis proportions, which by mid-2008, they had not. Because its predecessor fund had only just become fully invested, we started to slowly invest the reserve fund prior to Lehman's bankruptcy. In the market panic that followed Lehman's collapse, our first job was to figure out how best to proceed. Should we continue to invest the fund's capital or hold it in reserve? Or should we step on the gas? Was this the bottom? How could we determine what lay ahead? There was no history of financial sector meltdowns to rely on and no informed way to approach these questions given the uniqueness of the circumstances and the many unknowns. With the future unknowable, we applied the only analytical framework we could think of (simplistic though it was):

> I think the outlook has to be viewed as binary: will the world end or won't it? If you can't say yes, you have to say no and act accordingly. In particular, saying it will end would lead to inaction, while saying it's not going to will permit us to do the things that always have worked in the past.

> We will invest on the assumption that it will go on, that companies will make money, that they'll have value, and that buying claims on them at low prices will work in the long run. What alternative is there? . . .
>
> No one seems able to imagine how the current vicious circle will be interrupted. But I think we must assume it will be.
>
> It must be noted that, just like two years ago, people are accepting as true something that has never held true before. Then, it was the proposition that massively levered balance sheets had been rendered safe by the miracle of financial engineering. Today, it's the non-viability of the essential financial sector and its greatest institutions. . . . (*Nobody Knows*, September 19, 2008)

The above reasoning led us to conclude that if we invested and the financial world melted down, it wouldn't matter what we had done. But if we didn't invest and it didn't melt down, we wouldn't have done our job. So, we made the unsupportable assumption that the financial world would continue to exist and concluded that this meant we should invest aggressively. Bruce Karsh's team plunged in, investing an average of $400 million a week from September 18, 2008 through year-end – a total of $6 billion in, essentially, a single quarter. Purchases by the rest of Oaktree brought the total invested over that period to $7.5 billion.

We ran into very few people outside Oaktree who were putting money to work or willing to grant that we might be doing the right thing. I told a reporter friend we were buying, and he said – incredulously – "You are!?!"

Around the same time, I met with the CIO of a client institution as part of our efforts to raise equity to delever a fund that was perilously close to receiving a margin call, and **although I had good responses to all the increasingly negative scenarios she posited, we never got to a point where she would grant that "it can't be that bad."** This demonstration of unbridled pessimism – which appeared to be widespread at the time – convinced me that little optimism was embodied in the prices of the assets we were buying and thus that there was little chance of losing money. Here's how I put it in a memo I wrote that day:

> **Skepticism and pessimism aren't synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive. . . .**
>
> In the third stage of a bear market . . . everyone agrees things can only get worse. The risk in that – in terms of opportunity costs, or forgone profits – is equally clear. **There's no doubt in my mind that the bear market reached the third stage last week. That doesn't mean it can't decline further, or that a bull market's about to start. But it does mean the negatives are on the table, optimism is thoroughly lacking, and the greater long-term risk probably lies in not investing.**
>
> The excesses, mistakes and foolishness of the 2003-2007 upward leg of the cycle were the greatest I've ever witnessed. So has been the resulting panic. The damage that's been done to security prices may be enough to correct for those excesses – or too much or too little. But certainly it's a good time to pick among the rubble. (*The Limits to Negativism*, October 15, 2008)

Importantly, our confidence in investing the reserve fund's capital was enhanced by the fact that (a) we were buying the senior-most debt of high-quality companies that had been the subject of recent buyouts and (b) we were buying at prices so low that our debt holdings would do fine even if the companies ended up being worth only one-quarter or one-third of what the buyout funds had just paid for them.

Episodes like the visit with the apprehensive CIO told me the post-Lehman temperature of the market was too low. There was too much fear and too little greed, too much pessimism and too little optimism, and too much risk aversion and too little risk tolerance. Negative possibilities were being accepted as fact. **When these things are true, it stands to reason that (a) investor expectations are low; (b) asset prices probably aren't excessive; (c) there's little possibility of investors being disappointed; and (d) thus there's little likelihood of lasting loss and a good chance prices will work their way higher. In other words, this was the epitome of a buying opportunity.**

March 2012

After the TMT bubble burst in mid-2000, the S&P 500 dropped in 2000, 2001, and 2002, the first three-year stretch of negative returns since 1939. These declines caused many investors to lose interest in equities. Just a few years earlier, there had been widespread faith that stocks could never perform poorly for a meaningful period. Now, all of a sudden, such a time seemed to be at hand. Stocks delivered disillusionment, which can be one of the strongest forces in markets, and investors turned against them.

During the first few years of the aughts, the lack of appetite for equities – and for bonds, given how low the Fed had driven yields – caused many investors to conclude they couldn't earn their targeted returns through traditional asset classes. This, in turn, caused capital to flow to alternative investments, first hedge funds and then private equity. Soon investors were confronted by the Global Financial Crisis and the fear of financial-sector meltdown described above, which added to their negativity. These developments weighed heavily on investor psychology, and as a result, the S&P 500 was essentially flat from 2000 through 2011, returning an average of only 0.55% a year for the 12 years.

This is how things stood in March 2012, when I wrote the memo *Déjà Vu All Over Again*. My inspiration arrived when, sleepless while on a business trip in Chile, I reached into my Oaktree bag for something to read and came up with an old article I had wanted to revisit because I was sensing parallels between the current environment and the one the article described. It was "The Death of Equities," one of the most important magazine articles on investing of all time. It had appeared in *Businessweek* on August 13, 1979, following years of raging inflation, dreary economic news, and poor stock market performance.

In short, the article's theme was that no one would ever invest in stocks again because they had done so badly for so long. Here are a few of the article's observations:

> 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. . . .
>
> For investors . . . low stock prices remain a disincentive to buy. . . .
>
> 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. . . .
>
> It would take a sustained bull market for a couple of years to attract broad-based investor interest and restore confidence.

In other words, poor performance had led to investor disinterest, and disinterest had perpetuated the poor performance, creating one of the supposedly unstoppable vicious cycles we see in the markets from time to time. In the author's view, this negative state was likely to prevail for years.

Like many arguments in the world of investing, the assertions in "The Death of Equities" may have seemed sensible on the surface. **But if you drilled down a bit – and, in particular, if you thought like a contrarian – the logical flaws became readily apparent. What if the lows in optimism and enthusiasm for equities meant things couldn't get any worse? Wouldn't that mean they could only get better? And in that case, wouldn't it be reasonable to assume that low stock prices presaged future gains, not continued stagnation?**

The above paragraph captures in brief the difference between the thinking of the average investor and what I call "second-level thinking." The latter doesn't rely on first impressions; rather, it's deeper, more complex, and more nuanced. In particular, second-level thinkers understand that the convictions of the masses shape the market, but if those convictions are based on emotion instead of sober analysis, they should often be bet against, not backed. Here's how I put it in *Déjà Vu All Over Again*:

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

Thus, it would not have come as a surprise to the more sophisticated investor that "The Death of Equities" – perhaps the most sweepingly dour article ever written about the stock market – preceded one of (if not the) most positive periods in market history. In the 21 years from 1979 (when the article was written) through 1999 (just before the TMT bubble burst), the S&P 500's average annual return was 17.9%. That was nearly double its long-term average and **enough to turn $1 in 1979 into $32 in 1999!!** Once more from *Déjà Vu All Over Again*:

> Importantly, the stage had been set for this rise in 1979 by the accumulation and excessively pessimistic discounting of negatives. . . . **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. . . .**
>
> 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.

Rereading "The Death of Equities" in 2012 allowed me to immediately see parallels between the then-present day and the environment in which that article was written. Recent events had been highly negative, performance had been poor, and investor sentiment was depressed. That was enough to allow me – benefiting from the lessons of history – to adopt a positive stance:

> The story [in 2012] 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.

The result: From 2012 – the year of *Déjà Vu All Over Again* – through 2021, the S&P 500 returned 16.5% a year. Once again, excessively negative sentiment had resulted in major gains. It's as simple as that.

March 2020

The last of the five calls – recent enough for readers to recall the context – came in the early days of the Covid-19 pandemic. The disease began to enter most people's consciousness in February 2020, and from mid-February to mid-March, the S&P 500 fell by approximately one-third.

In *Nobody Knows II* (March 2020), my first memo during the pandemic, I cited Harvard epidemiologist Marc Lipsitch, who said on a podcast that when trying to understand the disease, there were (a) facts, (b) informed extrapolations from analogies to other viruses, and (c) opinion or speculation. But it was clear to me at the time that there were no "facts" regarding the pandemic's future course and no "history of other viruses" of comparable magnitude to extrapolate from. Thus, we were left with "opinion or speculation."

The bottom line of the above – simply put – is that we didn't know anything about what the future held. But whereas some people think ignorance regarding the future means they mustn't take any action, **someone who thinks the matter through logically and unemotionally should recognize that ignorance doesn't mean the position they're in is necessarily the position they should remain in.** (This is very much along the lines of Oaktree's post-Lehman thinking.)

Two weeks later, on March 19, 2020, I ended my client-only memo *Weekly Update* in a similar vein:

> I'll sum up my views simply – since there's nothing sophisticated to say:
>
> - "The bottom" is the day before the recovery begins. Thus it's absolutely impossible to know when the bottom has been reached . . . ever. Oaktree explicitly rejects the notion of waiting for the bottom; we buy when we can access value cheap.
> - Even though there's no way to say the bottom is at hand, the conditions that make bargains available certainly are materializing.
> - Given the price drops and selling we've seen so far, I believe this is a good time to invest, although of course it may prove not to have been the best time.
> - **No one can argue that you should spend all your money today . . . but equally, no one can argue that you shouldn't spend any.** (Emphasis added)

Whereas some of the market calls described earlier relied on knowledge of history and/or logical analysis, this recommendation was based primarily on acknowledgment of ignorance. All we knew for sure was that (a) there was a pandemic underway and (b) the U.S. stock market was down one-third. Doesn't it stand to reason, though, that however much money long-term investors had in stocks when the S&P 500 peaked at 3,386 in February, they should have considered adding to their positions when it hit 2,237 roughly a month later? That was the essence of my reasoning. Here's how I built up to the conclusion cited above:

> It's easy to say that something approaching panic is present in the markets. We've seen record percentage declines several times within the last month (exceeded since 1940 only by Black Monday – October 19, 1987 – when the S&P 500 declined by 20.4% in a day). This week and last included down days as follows: -7.6%, -9.5%, -12.0%, and -5.2% yesterday. These are enormous losses. . . .
>
> . . . there has been a rush to cash. Both long positions and short positions have been closed out – a sure sign of chaos and uncertainty. Cash in money market funds has

> increased substantially. This doesn't tell us anything about fundamentals, but the outlook for eventual market performance is improved:
>
> - the more people have sold,
> - the less they have left to sell, and
> - the more cash they have with which to buy when they turn less pessimistic. . . .
>
> [In the words of Justin Quaglia, one of our traders,] after two days of a basically stalled but stressed [bond] market, we "finally had the rubber band snap." Forced sellers (needing to sell for immediate cash flow needs) brought the market lower in a hurry. We opened 3-5 points lower, and the Street was again hesitant to take risk. . . .
>
> **We're never happy to have the events that bring on chaos, and especially not the ones that are underway today. But it's sentiment like Justin describes above that fuels the emotional selling that allows us to access the greatest bargains.** (*Weekly Update*, emphasis added)

While neither a historical foundation nor rigorous quantitative analysis was achievable, the above paragraphs indicate that one could still logically determine an appropriate course of action. As I wrote in that same memo:

> What do we know? Not much other than the fact that asset prices are well down, asset holders' ability to hold coolly is evaporating, and motivated selling is picking up.

But that was enough. Paralysis wasn't called for, but rather steps that could help us take advantage of most investors' panic and the resulting dramatic price declines. Sometimes it's as simple as that. When the knee-jerk reaction of most investors is to stand pat or sell, a contrarian decision to buy might well be called for. Doing so is never easy, though, and mid-March 2020 was one of the most challenging environments I've ever worked through. But the key, as Rudyard Kipling wrote in the poem "If," is to "keep your head when all about you are losing theirs. . ."

<u>How Can You Do It?</u>

I spent the preceding pages describing these five calls not for purposes of self-congratulation but rather to lay the groundwork for a discussion of how one can make useful observations regarding the status of the markets. **Hopefully we learn from our experiences as we go through life. But to really learn from them, we have to step back on occasion, look at an entire string of events, and figure out the following: (a) what happened, (b) is there a pattern that has repeated, and (c) what are the lessons to be learned from the pattern?**

Once in a while – once or twice a decade, perhaps – markets go so high or so low that the argument for action is compelling and the probability of being right is high. As my son helped me to recognize, I had identified five of those, and they paid off. But what if I'd tried to make 50 market calls in my 50 years . . . or 500? By definition, I would have been making judgments about markets that were closer to the middle ground – perhaps a little high or a little low, but not so extreme as to permit dependable conclusions. Investors' records of success with calls in markets like these are poor, since even if they're right about asset prices being out of line, it's very easy for something that's a little overpriced to go on to become demonstrably more so, and then to turn into a raging bubble, and vice versa. In fact, if we could rely on small mispricings to always correct promptly, they would never grow into the manias, bubbles, and crashes we see from time to time.

So, one key is to avoid making macro calls too often. I wouldn't want to try to make a living predicting the outcome of coin tosses or figuring out whether the favorite will cover the point spread in every football game over the course of a season. You have to pick your spots – as Warren Buffett puts it, wait for a fat pitch. Most of the time, you have nothing to lose by abstaining from trying to adroitly get in and out of the markets: you merely participate in their long-term trends, and those have been very favorable.

My readers know I don't think consistently profitable market calls can be manufactured out of macroeconomic forecasts. Nor do I believe you can beat the market simply by analyzing company reports. On both subjects, as Andrew puts it (see my memo *Something of Value*, January 2021), "readily available quantitative data regarding the past and present" can't hold the secret to superior performance since it's available to everyone.

When markets are at extreme highs or lows, the essential requirement for achieving a superior view of their future performance lies in understanding what's responsible for the current conditions. Everyone can study economics, finance, and accounting and learn how the markets are supposed to work. But superior investment results come from exploiting the differences between how things are supposed to work and how they actually do work in the real world. To do that, the essential inputs aren't economic data or financial statement analysis. The key lies in understanding prevailing investor psychology.

For me, the things one must do fall under the general heading of "taking the temperature of the market." I'll itemize the most essential components here:

- **Engage in pattern recognition.** Study market history in order to better understand the implications of today's events. Ironically, when viewed over the long term, investor psychology and thus market cycles – which seem flighty and unpredictable – fluctuate in ways that approach dependability (if you're willing to overlook their highly variable causality, timing, and amplitude).
- **Understand that cycles stem from what I call "excesses and corrections"** and that a strong movement in one direction is more likely to be followed – sooner or later – by a correction in the opposite direction than by a trend that "grows to the sky."
- **Watch for moments when most people are so optimistic that they think things can only get better**, an expression that usually serves to justify the dangerous view that "there's no price too high." Likewise, recognize when people are so depressed that they conclude things can only get worse, as this often means they think a sale at any price is a good sale. When the herd's thinking is either Pollyannaish or apocalyptic, the odds increase that the current price level and direction are unsustainable.
- **Remember that in extreme times, because of the above, the secret to making money lies in contrarianism, not conformity.** When emotional investors take an extreme view of an asset's future and, as a result, take the price to unjustified levels, the "easy money" is usually made by doing the opposite. **This is, however, very different from simply diverging from the consensus all the time.** Indeed, most of the time, the consensus is as close to right as most individuals can get. So to be successful at contrarianism, you have to understand (a) what the herd is doing, (b) why it's doing it, (c) what's wrong with it, and (d) what should be done instead and why.
- **Bear in mind that much of what happens in economies and markets doesn't result from a mechanical process, but from the to and fro of investors' emotions.** Take note of the swings and capitalize whenever possible.
- **Resist your own emotionality.** Stand apart from the crowd and its psychology; don't join in!

- **Be on the lookout for illogical propositions** (such as "stocks have fallen so far that no one will be interested in them"). When you come across a widely accepted proposition that doesn't make sense or one you find too good to be true (or too bad to be true), take appropriate action. See something; do something.

Obviously, there's a lot to grapple with when taking the temperature of the market. In my opinion, it has more to do with clear-eyed observations and assessments of the implications of what you see than with computers, financial data, or calculations.

I'll go into additional depth on a couple of points:

On pattern recognition: You may have noticed that the first of the five calls described above was made in 2000, when I had already been working in the investment industry for more than 30 years. Does this mean there were no highs and lows to remark on in those earlier years? No, I think it means it took me that long to gain the insight and experience needed to detect the market's excesses.

Most notably, whereas I spent two pages above describing the profound error in "The Death of Equities," you may have noticed that I didn't say anything about my having called out the article when it appeared in *Businessweek* in 1979. The reason is simple: I didn't. I had only been in this business for about a decade at that point, so (a) I didn't have the experience needed to recognize the article's error and (b) I had yet to develop the unemotional stance and contrarian approach needed to depart from the herd and rebel against its thesis. **The best I can say is that my eventual development of those attributes enabled me to catch the same error when it arose again 33 years later.** Pattern recognition is an important part of what we do, but it seems to require time in the field – and some scars – rather than just book learning.

On cycles: In my book *Mastering the Market Cycle*, I defined cycles not as a series of up and down movements, each of which regularly **precedes** the next – which I believe is the usual definition – but as a series of events, each of which **causes** the next. This causality holds the key to understanding cycles. In particular, I think economies, investor psychology, and thus markets eventually go too far in one direction or another – they become too positive or too negative – and afterward they eventually swing back toward moderation (and then usually toward excess in the opposite direction). **Thus, in my opinion, these cycles are best understood as stemming from "excesses and corrections."** Overlooking the details of the individual episodes, it's clear from the descriptions of these five calls that the greatest opportunities for bargain purchases result from overly negative prevailing psychology and the greatest opportunities to sell at too-high prices arise from excessive optimism.

Macro Calls and the Oaktree Culture

While on the subject of market calls, I want to touch on two questions I've received repeatedly since the publication of my memo *The Illusion of Knowledge* (September 2022), which discussed why I believe creating helpful macro forecasts is so challenging. How does making these market calls fit within Oaktree's investment approach? And how can we make "micro forecasts" concerning companies, industries, and securities without predicting the macro context?

In 1995, when my four Oaktree co-founders and I decided to form a new firm, we'd already been working together for nine years on average. To come up with an investment philosophy that would guide the new entity, we only had to reflect on what had worked for us up to that point and what we believed in. This led us to write down the six tenets that describe how we invest, and we haven't changed a word in 28 years.

Of the six tenets, two raise questions regarding how macro calls fit within Oaktree's investment approach:

- Number five: "We don't base our investment decisions on macro forecasts."
- Number six: "We're not market timers."

How about the first of those? It's easy to say you don't invest on the basis of macro forecasts, and I've been saying this for decades. **But the truth is, if you're a bottom-up investor, you make estimates regarding future earnings and/or asset values, and those estimates have to be predicated on assumptions regarding the macro environment.** Certainly, you can't predict a business's results in a given period without considering what'll be going on in the economy at that point. So, then, what does avoiding macro forecasting mean to us? My answer is as follows:

- We generally assume the macro environment of the future will resemble past norms.
- We then make allowance for the possibility that things will be worse than normal. Ensuring our investments have a generous "margin of safety" makes it more likely they'll do okay even if future macro developments disappoint somewhat.
- **What we never do is project that the macro environment will be distinctly better than normal** in some way, making winners out of particular investments. Doing so can lead to profits if one is right, but it's hard to consistently make such forecasts correctly. Further, investments reliant on favorable macro developments can expose investors to the possibility of disappointment, leading to loss**. It's our goal to construct portfolios where the surprises will be on the upside. Relying on optimistic underlying assumptions is rarely part of such a process. We prefer to make assumptions I would describe as "neutral."**

So we do base our modeling on macro assumptions – by necessity – but rarely are those assumptions boldly idiosyncratic or optimistic. We never base our investment decisions on the mistaken belief that we (or anyone else) can predict the future. Thus, we recognize that the above average results we seek must arise from our ground-up insights and not from our ability to do a superior job of forecasting unusual macro events.

You might ask here, "What about the memo *Sea Change* and its assertion that we may be seeing a shift toward a wholly different environment?" My answer is that I feel good about this memo because (a) it's mostly a review of recent history and (b) the important observations surround the unusual nature of the 2009-21 period, its effect on investment outcomes, and the improbability of it repeating. (I'm particularly comfortable saying interest rates aren't going to decline by another 2,000 basis points from here.) While it's important to stick to guiding principles, it's also essential to recognize and respond to real change when it happens. Thus, I stand by *Sea Change* (my only expression of an opinion of this kind in my entire working life) as an acceptable deviation from my standard practice. For me, the case for a sea change has more to do with **observing and inferring** than it does with **predicting**.

And what about market timing? As I've written numerous times since developing my risk-posture framework a few years ago, every investor should operate most of the time in the context of their normal risk posture, by which I mean the balance between aggressiveness and defensiveness that's right for them. It makes perfect sense to try to vary that balance when circumstances dictate compellingly that you should do so and your judgments have a high probability of being correct, like in the case of the five calls I've discussed. But such occasions are rare.

So, we stay in our normal balance – which in Oaktree's case implies a bias toward defensiveness – unless compelled to do otherwise. But we are willing to make changes in our balance between aggressiveness and defensiveness, and we have done so successfully in the past. In fact, I consider one of my principal responsibilities to be thinking about the proper balance for Oaktree at any given time.

If we're happy to vary our risk posture, then what does it mean when we say, "we're not market timers"? For me, it means the following:

- **We don't sell things we consider attractive long-term holdings to raise cash in expectation of a market decline.** We usually sell because (a) a holding has reached our target price, (b) the investment case has deteriorated, or (c) we've found something better. Our open-end portfolios are almost always fully invested; that way we avoid the risk of missing out on positive returns. It also means buying usually necessitates some selling.
- **We don't say, "It's cheap today, but it'll be cheaper in six months, so we'll wait."** If it's cheap, we buy. If it gets cheaper and we conclude the thesis is still intact, we buy more. We're much more afraid of missing a bargain-priced opportunity than we are of starting to buy a good thing too early. No one really knows whether something will get cheaper in the days and weeks ahead – that's a matter of predicting investor psychology, which is somewhere between challenging and impossible. We feel we're much more likely to correctly gauge the value of individual assets.

While on the subject of buying too soon, I want to spend a minute on an interesting question: Which is worse, buying at the top or selling at the bottom? For me the answer is easy: the latter. If you buy at what later turns out to have been a market top, you'll suffer a downward fluctuation. But that isn't cause for concern if the long-term thesis remains intact. And, anyway, the next top is usually higher than the last top, meaning you're likely to be ahead eventually. But if you sell at a market bottom, you render that downward fluctuation permanent, and, even more importantly, you get off the escalator of a rising economy and rising markets that has made so many long-term investors rich. This is why I describe selling at the bottom as the cardinal sin in investing.

* * *

Thinking about the macro environment and how it influences our proper risk posture falls squarely within our responsibilities as investment managers. But the bottom line is that, at Oaktree, we approach these things with great humility, diverging from our neutral assumptions and normal behavior only when circumstances leave us no other choice. "Five times in 50 years" gives you an idea about our level of interest in being market timers. The fact is, we do so hesitantly.

July 10, 2023

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Memo to: Oaktree Clients

From: Howard Marks

Re: Fewer Losers, or More Winners?

My memos got their start in October 1990, inspired by an interesting juxtaposition between two events. One was a dinner in Minneapolis with David VanBenschoten, who was the head of the General Mills pension fund. Dave told me that, in his 14 years in the job, the fund's equity return had never ranked above the 27th percentile of the pension fund universe or below the 47th percentile. And where did those solidly second-quartile annual returns place the fund for the 14 years overall? Fourth percentile! I was wowed. It turns out that most investors aiming for top-decile performance eventually shoot themselves in the foot, but Dave never did.

Around the same time, a prominent value investing firm reported terrible results, causing its president to issue an easy rationalization: "If you want to be in the top 5% of money managers, you have to be willing to be in the bottom 5%, too." My reaction was immediate: "My clients don't care whether I'm in the top 5% in any single year, and they (and I) have absolutely no interest in me ever being in the bottom 5%."

These two events had a strong influence on me and helped define my – and what five years later became Oaktree's – investment philosophy, which emphasizes risk control and consistency above all. Here's how I put it 33 years ago in that first memo, titled *The Route to Performance*:

> I feel strongly that attempting to achieve a superior long-term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year – and through discipline to have highly superior relative results in bad times – is:
>
> - less likely to produce extreme volatility,
> - less likely to produce huge losses which can't be recouped and, most importantly,
> - more likely to work (given the fact that all of us are only human).
>
> Simply put, what [General Mills's] record tells me is that, in equities, if you can avoid losers (and losing years), the winners will take care of themselves. I believe most strongly that this holds true in my group's opportunistic niches as well – that the best foundation for above-average long-term performance is an absence of disasters.

As you can see, my dinner with Dave was a seminal event; his approach was clearly the one for me. (Incidentally, I want to share that after decades of not having been in touch, Dave was among the many kind people who wrote in recent months to encourage me vis-à-vis my health issue. This is a great example of the many personal dividends my career has paid.)

<u>Putting It in Brief</u>

That first memo, and the bit cited above, include a phrase you've likely heard from Oaktree: **If we avoid the losers, the winners will take care of themselves.** My partners and I considered this phrase so fitting that we adopted it as our motto when Oaktree was formed in 1995. Our reasoning was simple: If we invest in a diversified portfolio of bonds and are able to avoid the ones that default, some of the non-defaulters we buy will benefit from positive events, such as upgrades and takeovers. That is, the winners will materialize without our having explicitly sought them out.

We thought that phrase was innovative. But in 2005, while working with Seth Klarman to update the 1940 edition of Benjamin Graham and David Dodd's *Security Analysis* – the "bible of value investing" – I read something that indicated we were late by about 50 years. In the section Seth asked me to edit, I came across Graham and Dodd's description of "fixed-value" (or fixed-income) investing as "a negative art." What did they mean?

At first, I found their observation cynical, but then I realized what they were saying. Let's assume there are one hundred 8% bonds outstanding. Let's further assume that ninety will pay interest and principal as promised and ten will default. Since they're all 8% bonds, all the ones that pay will deliver the same 8% return – it doesn't matter which ones you bought. The only thing that matters is whether you bought any of the ten that defaulted. In other words, bond investors improve their performance not through what they buy, but through what they exclude – not by finding winners, but by avoiding losers. There it is: a negative art.

One more anecdote concerning the origin of the phrase: I've always been interested in old books. A few years ago, while walking through a Las Vegas convention center on the way to meet with a client, I came upon a rare book fair. I stopped at the booth of a book dealer I know, and my eye immediately fell on a book he had for sale: *How to Trade in Stocks,* by Jesse Livermore. Here's the quote the dealer had highlighted: "Winners take care of themselves; losers never do." You may be tempted to believe Livermore borrowed my idea . . . until you realize that, like Graham and Dodd, he published these lines in 1940. So much for my innovation.

At the time I adopted that saying, my partners and I were primarily high yield bond investors. And since non-convertible bonds have little upside potential beyond their promised yield to maturity, it truly was the case that our main job was to avoid the non-payers, with the assumption that some subset of the payers would likely give us exposure to positive developments that occurred. It was an appropriate way to sum up our approach as bond investors.

But fortunately, I joined up with Bruce Karsh in 1987, and in 1988 we organized our first distressed debt fund. Now we were investing in bonds that had defaulted or seemed likely to do so. We thought we might be able to buy them at bargain prices because of the cloud they were under, giving us the possibility of capital appreciation. Bruce has since become well known for his investing acumen, and, certainly, his returns since 1988 can't be attributed to the mere avoidance of losses. **When you aspire to returns well above those available on bonds, it's not enough to avoid losers; you actually have to find (or create) winners from time to time.** The returns generated by Bruce and his group show that they've done so.

Oaktree now has a number of what I call "aspirational strategies," meaning they need winners. **So why do we still use the above phrase as our motto, and why is "the primacy of risk control" still the first tenet of our investment philosophy?** The answer is we want the concept of risk control to always be top of mind for our investment professionals. When they review a security, we want them to ask not only "How much money can I make if things go well?" but also "What will happen if events don't go as planned? How much could I lose if things get bad? And how bad would things have to get?"

Risk control is still number one at Oaktree. Seventy-plus years ago, UCLA football coach Henry Russell "Red" Sanders said, "Winning isn't everything, it's the only thing." (The saying is also attributed to Vince Lombardi, legendary football coach of the Green Bay Packers.) While I haven't figured out exactly what that phrase means, I'm firmly convinced that **for Oaktree, risk control isn't everything; it is the only thing.**

Not Risk Avoidance

Understanding the distinction between risk control and risk avoidance is truly essential for investors. Risk avoidance basically consists of not doing anything where the outcome is uncertain and could be negative. And yet, at its heart, investing consists of bearing uncertainty in the pursuit of attractive returns. For this reason, risk avoidance usually equates to return avoidance. You can avoid risk by buying Treasury bills or putting your money into government-insured deposits, but there's a reason why the returns on these are generally the lowest available in the investment world. Why should you be well paid for parting with your money for a while if you're sure to get it back?

Risk control, on the other hand, consists of declining to take risks that (a) exceed the quantum of risk you want to live with and/or (b) you wouldn't be well rewarded for bearing. I've written in the past about what I call "the intelligent bearing of risk for profit." Here's the backstory:

I got my start managing money in 1978, when Citi asked me to run portfolios of convertibles and high yield bonds. The former were mostly non-investment grade securities issued by companies that had no alternative when seeking to raise capital, and the latter were, according to the terminology of the day, low-rated "junk bonds." Clearly, they both entailed significant credit risk. Around 1980, a reporter from one of the first financial news networks asked me a provocative question: "How can you buy high yield bonds when you know some of the issuers are going to default?" My response captured the essence of intelligent risk bearing: "How can life insurance companies insure people's lives when they know they're all going to die?"

The point is simple: These functions can both be performed in an intelligent, risk-controlled way. For that to be the case, the risk has to be:

- risk you're aware of,
- risk you can analyze,
- risk you can diversify, and
- risk you're well paid to assume.

Risks like this needn't be avoided. If you have real insight, such risks can be borne prudently and profitably.

I know several investors who take much more risk than Oaktree does and whose bad years are much worse than ours. But the few who possess genuine skill – what I call "alpha" (more on that later) – produce jumbo returns in their good years, such that their long-term returns are exceptional. Their clients are well rewarded . . . assuming they have enough intestinal fortitude to hang in through the bad years. Thus, risk-taking isn't unwise per se, and risk avoidance is appropriate only for investors who feel they can't survive tough times.

Building a Good Record

Since (a) all but the most cautious investing entails risk and (b) the presence of risk means results will be unpredictable and inconsistent, very few (if any) investors are able to have only good years or to assemble portfolios that contain only winners. **The question isn't whether you're going to have losers, but rather how many and how bad relative to your winners.**

Warren Buffett – arguably the investor with the best long-term record (and certainly the longest long-term record) – is widely described as having had only twelve great winners in his career. His partner Charlie Munger told me the vast majority of his own wealth came not from twelve winners, but only four. I believe the ingredients of Warren's and Charlie's great performance are simple: (a) a lot of investments in which they did decently, (b) a relatively small number of big winners that they invested in heavily and held for decades, and (c) relatively few big losers. No one should expect to have – or expect their money managers to have – all big winners and no losers.

In fact, not having any losers isn't a useful goal. The only sure way to achieve that is by not taking any risk. But, as I said earlier, risk avoidance is likely to result in return avoidance. **There's such a thing as the risk of taking too little risk.** Most people understand this intellectually, **but human nature makes it hard for many to accept the idea that the willingness to live with some losses is an essential ingredient in investment success.**

Having watched some great tennis this summer – right through the U.S. Open this past weekend – I'll recycle a tennis analogy I first suggested in my memo *Dare to Be Great II* (April 2014). What if I went out to play tennis and said, "Today, I'm not going to commit any service faults"? My serves would have to be so meek that my opponent would likely destroy them. **Tennis players have to take some risk if they hope to succeed** (see below). If none of your serves fall outside the service box, you're probably serving too cautiously to win. The same is true of investing. As my long-time partner Sheldon Stone puts it, "If you don't experience any defaults, you're probably not taking enough credit risk."

Winners' Stats

Looking back, it turns out I devoted an entire memo to analogies between investing and sports once per decade in the 1990s, the 2000s, and the 2010s. This time, in my fourth decade of memo-writing, I'm going to devote a few more paragraphs to tennis.

As mentioned above, tennis makes for very apt comparisons to investing. Hit safely and get blasted? Or try for shots you can't make consistently and beat yourself? Charles D. Ellis's article "The Loser's Game" (*The Financial Analysts Journal*, July/August 1975) was truly seminal in my development as an investor. He pointed out that there are two kinds of tennis players . . . actually, two different types of tennis games. Professionals play a winner's game: **They win by hitting winners** (in tennis, that means shots the opponent can't return). Since their game is so much within their control, they can usually produce the shots they want, the best of which win points. But amateur tennis is a loser's game: **The winner is usually the person who hits the fewest losers.** If you can just keep the ball in play long enough, eventually your opponent will hit it off the court or into the net. The amateur doesn't have to hit winners to win, and that's a good thing, because he or she generally is incapable of doing so dependably.

A quick look at some statistics from this year's Wimbledon provides a great deal of food for thought. I'll look first at the men's quarterfinal match between Daniil Medvedev, the #3 seed in the tournament, and unseeded Christopher Eubanks. Eubanks, 6'7" and highly athletic, surprised everyone with his rush to the quarterfinals. But, in Medvedev, he was playing someone who's spent years trailing just behind the "big three" of men's tennis: Novak Djokovic, Rafael Nadal, and Roger Federer.

As a pronounced underdog, Eubanks probably recognized that he wasn't likely to outlast or out-steady Medvedev. Thus, he had to go for winners. If that was Eubanks's plan, he succeeded in executing it. He achieved 74 winners to Medvedev's 52, and he aggressively rushed the net 67 times (for 44 winners) compared to Medvedev's 8 (for 4 winners). These are great offensive stats.

The problem is that – as I've experienced firsthand many times – if you're up against a player who's better than you are, you have to attempt shots that aren't firmly within your competence in order to have a hope of winning. Thus, along with his 74 winners, Eubanks was guilty of 55 unforced errors (mistakes that aren't forced by good shots from one's opponent; the easy way to make an unforced error is to go for a winner and miss). In comparison, Medvedev committed only 13 unforced errors.

Bottom line: Eubanks had considerably more winners than Medvedev, but he had three unforced errors for every four winners, whereas Medvedev had only one per four. Medvedev won 53% of the points played versus Eubanks's 47%, and thus he won the match. The lesson is that it's not enough to have more winners. To win – in tennis as in investing – you have to have a favorable relationship between winners and losers. **You can win by having a few winners but fewer losers or by having a lot of losers but more winners. Neither maximizing winners nor minimizing losers is necessarily enough. It's all in the balance.**

And that leads me to the Wimbledon men's final. This exciting match pitted Djokovic, who had won the most Grand Slam championships in history (23 combined at Wimbledon, the U.S. Open, the French Open, and the Australian Open), against up-and-coming 20-year-old Carlos Alcaraz, who had a grand total of one. Like Eubanks, Alcaraz plays a big, athletic game and goes for a lot of winners. You can see that in his serving: Alcaraz had seven double faults, more than twice Djokovic's three. But, again, a single statistic tells us very little, since Alcaraz's attempts at big serves gave him nine aces (serves his opponent couldn't even get his racquet on), more than four times Djokovic's two. This is an indication of the players' respective styles. In the end, Alcaraz won the match with 66 winners, whereas Djokovic had only 32.

So, Alcaraz beat Djokovic with a "bigger," high-risk game, while Medvedev beat Eubanks with his steadier, risk-controlled style. **Neither approach is better than the other per se. Style alone never determines outcome; it's a matter of style plus execution.** My tennis teacher, Jordi Ballester, explains: "Alcaraz plays a more aggressive game. Given his high level of talent, as he showed at Wimbledon, if he has a good day, he can beat Djokovic (or any other opponent). If he's off, he may well lose."

It's interesting to note that tennis's big three presided over an incredible era. In the 19 years leading up to Wimbledon 2023, they won a combined 65 – or 87% – of the 75 Grand Slam championships. Notably, none of them was a "big hitter" in Alcaraz's mold. **Their ability to hit at a fabulous level for four or five hours without committing many errors was usually enough.**

The Need for Winning Stocks

There have been several times over the course of my career when a small number of stocks have accounted for a disproportionately large share of the market's gains. In this regard, a lot has been written about the so-called "magnificent seven": Apple, Microsoft, Alphabet (owner of Google), Amazon, Nvidia, Tesla, and Meta (owner of Facebook). At various points in time this year, these seven stocks accounted for most or all of the gains of various equity indices. Here's how the *Financial Times* put it in June:

> Seven of the biggest constituents . . . have ripped higher, gaining between 40 per cent and 180 per cent this year. The remaining 493 companies [in the Standard & Poor's 500 stock index] are, in aggregate, flat.

> Big tech companies dominate the index to an unprecedented degree. Just five of those seven stocks represent nearly a quarter of the market capitalisation of the entire index. ("The seven companies driving the US stock market rally," *Financial Times*, June 14, 2023.)

The extent of these stocks' outperformance for much of this year may be unique, but the phenomenon is not. It was also the case in 2017 that a few stocks were largely responsible for carrying the market upward. Then it was the "FAANGs": Facebook, Amazon, Apple, Netflix, and Google/Alphabet. The *Financial Times* highlighted this history as well:

> Top-heaviness, particularly in US markets, is not new. "The big tech stocks in the S&P now are the same situation as oil companies were in the past, or the Nifty 50 in the 1960s," says Frédéric Leroux, head of the cross-asset team at Carmignac in Paris – a nod to the craze that swept shares in a small number of fast-growing companies such as IBM, Kodak and Xerox higher before a heavy decline set in. "It's a problem, but it's a recurring problem." (Ibid.)

For as long as most of us can remember, active investors have had a tough time keeping up with the equity indices. For this reason, in recent decades, passive investing has taken a substantial share of equity capital invested. Active investing's shortfall has been attributed primarily to the combination of market efficiency, management fees, and investor error. I think there's another reason: active investors' need for winners.

What if you didn't own the magnificent seven earlier this year? Clearly, you'd be far behind the indices. What if you owned them, but in smaller proportions than their weightings in the indices? You'd still lag, but by a smaller amount. **So, by definition, keeping up with the indices requires having exposure to the big winners that is at least equal to their representation in the indices.** That much seems clear.

Now, think about that representation. Let's say you started off 20 years ago – in the summer of 2003 – with an index-sized helping of Apple at a split-adjusted price of $0.37. The key question is simple: **Would you have held on as it rose?**

As I described in my memo *Selling Out* (January 2022), most investors subscribe to the conventional wisdom of "taking profits," "taking some money off the table," or "topping the trees." After all, as the old saying goes, "No one ever went broke taking profits." Investors often sell off some of their winners for the simple reason that they're afraid to watch as they give up their gains, which can lead to regret, criticism from clients, and/or lost accounts.

Most people would have sold part or all of their Apple holding by the time the price reached $15 in the summer of 2013. What would you have done when it hit 40 times your original cost after 10 years?

Today, another 10 years later, Apple is around $180[1] – up 12x since 2013 and up by almost 500x since 2003. The point is, in the face of these gains, very few investors would still hold all they'd originally bought. **But if they sold Apple stock when the constructors of the index didn't, they've probably failed to keep up with the index.** The situation can be summed up as follows:

[1] This reflects the price as of September 8, 2023.

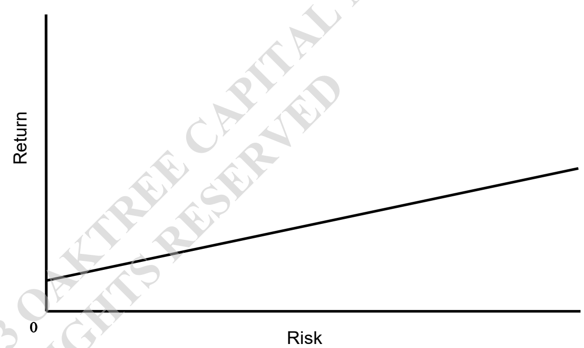
- The performance of the equity indices is often dominated by a few stocks or groups of stocks.
- The gains of the leaders can make them seem expensive, arguing for profit-taking.
- Human nature – especially the desire to avoid regret – adds to the motivation to sell.
- By definition, if you reduce your holdings of the winners relative to their representation in the indices and these winners continue to outperform, you'll have a tough time keeping up.

In my memo *Liquidity* (March 2015), I included an insight from my son Andrew. To paraphrase, he said, "If you look at the chart of a stock that's been up for 25 years and say, 'Man, I wish I'd owned that stock,' think about all the days you would have had to talk yourself out of selling." I doubt many people watched Apple go from $0.37 to $180 without selling any. How many active investors would allow Apple shares to constitute nearly 8% of their portfolios, which was its weight in the S&P 500 at the recent peak? But – to oversimplify – if they sold Apple, they've lagged.

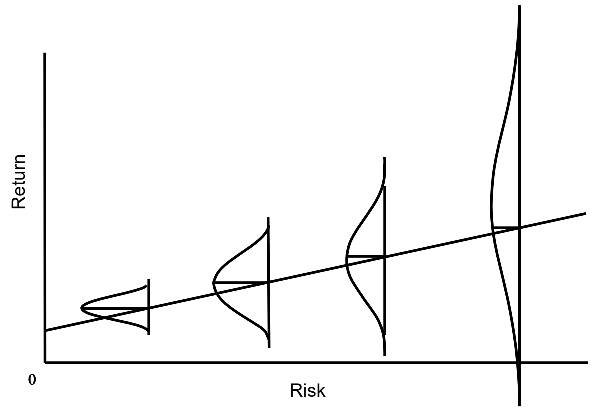
The bottom line is that winners aren't entirely dispensable. If you hope to at least keep up with the indices, you probably have to have an average representation in them. (This isn't entirely inescapable. You might also achieve that goal by holding fewer of the losers.)

The Role of Risk Bearing

I'm going to conclude this memo using my favorite graph. When I attended graduate school at the University of Chicago 55 (!) years ago, I was taught to view the relationship between risk and return as follows:

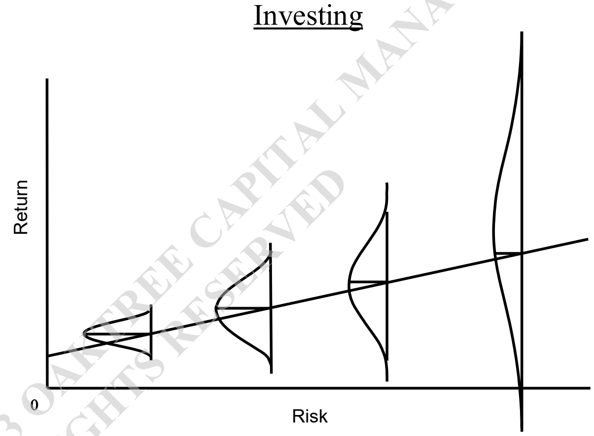


But the more I thought about it, the more unhappy I was with the way the linear presentation of the purported relationship tells investors that they can count on achieving higher returns as a result of taking more risk. After all, if that were really the case, risky investments wouldn't be riskier. Thus, in my memo *Risk* (January 2006), I suggested a different way of depicting the relationship by superimposing on the line a series of bell-shaped probability distributions turned on their side:



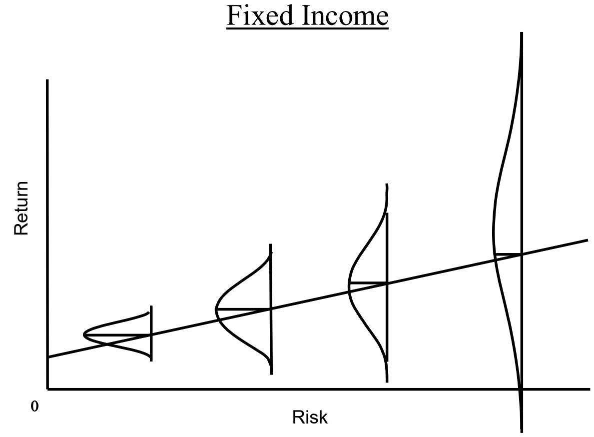
Rather than implying that taking more risk – moving from left to right in the graph – assures higher returns, this new way of looking at the relationship suggests that as you take more risk, (a) the expected return increases, as per the original version above; (b) the range of possible outcomes becomes wider; and (c) the bad possibilities become worse. In other words, riskier investments introduce the potential for higher returns, but also the possibility of other less-desirable side effects. That's why they're described as being riskier. Since writing that memo, I've concluded that this way of thinking about things has a great many applications. Here are a few:

<u>Investing</u>



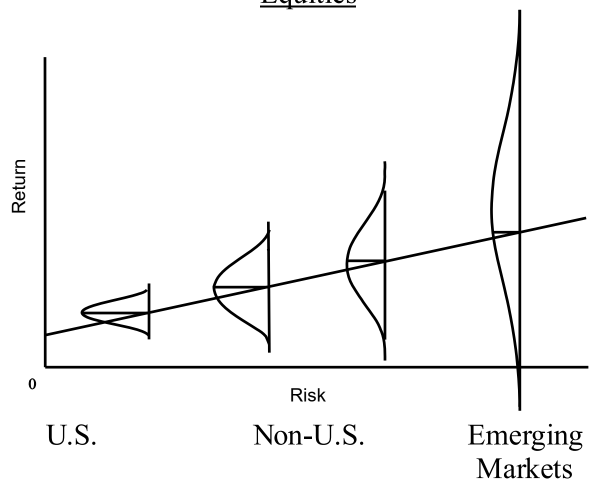
Bonds Equities Venture Capital

<u>Fixed Income</u>



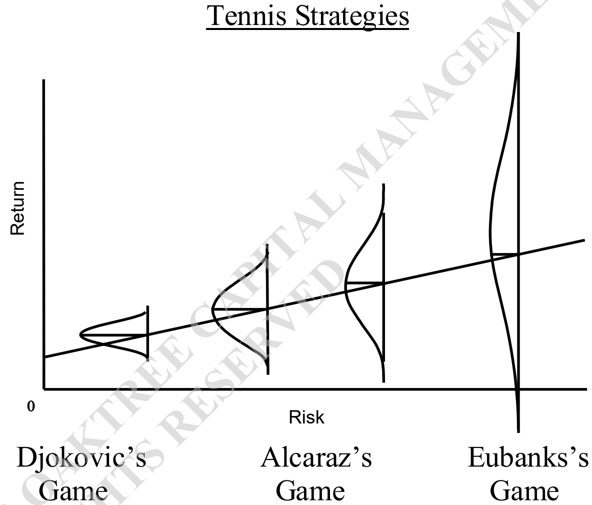
Treasurys Corporates High Yield Bonds

Equities



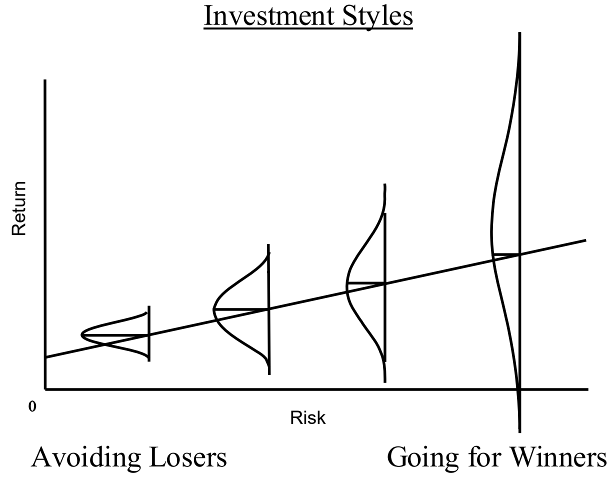
There are also applications for this way of seeing things outside the investment world. For example:

Tennis Strategies



And that brings me back to the subject of this memo:

Investment Styles



As the above graphs indicate, a high-risk approach introduces the potential for huge returns . . . as well as the possibility of loss.

So, where's the right place to be on this spectrum? Where can one find the best risk/return bargains? The short answer is that, according to investment theory – particularly the Efficient Market Hypothesis – there are no better (or worse) places to be. **The EMH says markets price securities such that (a) their price equals their intrinsic value and (b) bearing incremental risk is rewarded fairly.** Thus, bargains and over-pricings can't exist. This is why, according to the theory, "you can't beat the market."

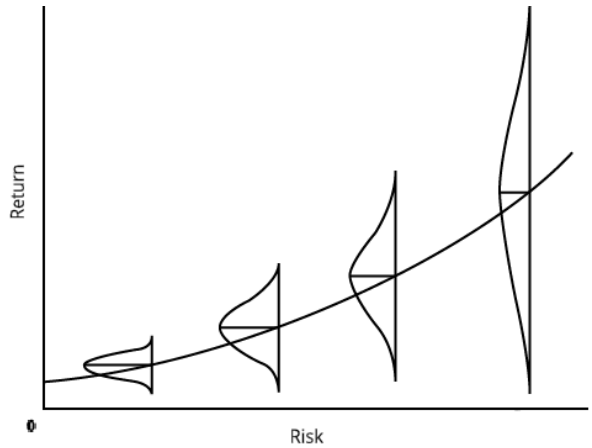
The theory also suggests that if a market is at "equilibrium," each change in prospective return is fair relative to the change in risk borne, such that all positions on the curve are equivalent in attractiveness. Move to the left, and you avoid some risk, but your prospective return drops. Move to the right, and your prospective return increases, but so does your risk. No position on the spectrum is superior to any other. It's like a coin toss (which the EMH suggests active investing is): Neither heads nor tails is the smarter call.

<u>What About in Practice?</u>

One of my favorite quotes is attributed to Albert Einstein and Yogi Berra, among others: "In theory, there is no difference between theory and practice. In practice, there is." If markets are efficient and securities are always priced correctly, there can be no value in active investing. The truth is that many active managers, especially in developed market equities, have failed to demonstrate the ability to add value, or to add enough value to justify their management fees. This is largely why index funds were created and why a significant amount of equity capital has migrated to index and passive investing in recent decades.

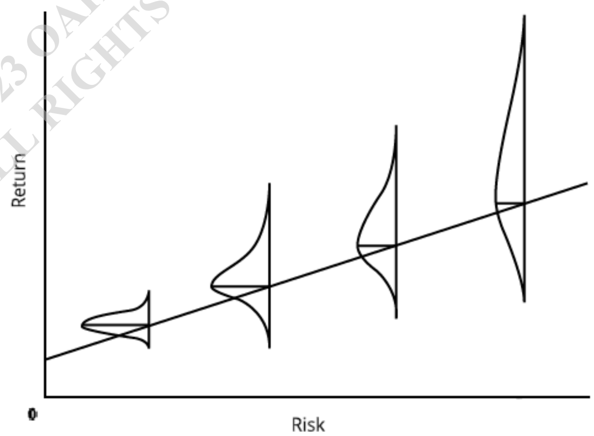
And yet, I firmly believe there are times when the markets are overpriced and times when they're underpriced. There are also times when particular markets or sectors are overpriced or underpriced relative to others. In these instances, some securities can be priced too high or too low, and thus some positions on the risk curve can offer better bargains than others.

The theory assumes investors are rational and objective, but psychological excesses violate that assumption. Take, for example, the investment environment during the Global Financial Crisis. As I described in my July memo *Taking the Temperature*, in late 2008, investors were so worried about a financial sector meltdown that they panicked and sold securities aggressively as their prices collapsed. Excessive risk aversion causes the risk/return line to steepen (increasing the return for each incremental unit of risk borne) and perhaps even to curve upward (rendering the compensation for making investments at the risky end of the spectrum disproportionately generous). Thus, in periods of excessive risk aversion, the riskier part of the curve can be the smarter place to be (and in periods when risk bearing is too eagerly embraced, the safer part can offer a superior proposition).



The last element I want to touch on is what I call "alpha," or individual investing skill. The reason the EMH disdains efforts to beat the market is its conviction that since securities are always priced correctly, the ability to identify bargains to buy and over-pricings to avoid can't exist. Theory's assertion that there's no such thing as mastery of markets implies that no one has the skill to assemble portfolios that outperform. This is why I depict the bell-shaped curves above as symmetrical: In an efficient market, investors can only take what the market gives them.

But I'm convinced the potential to improve on that through skill does exist in some markets and some people. **Investors who possess alpha have the ability to alter the shape of the distributions in the graphs above so that they're not symmetrical, in that the portion of the distribution representing the less desirable outcomes is smaller than the portion representing the better ones. In fact, that's what alpha really means: Investors with alpha can go into a market and, by applying their skill, access the upside potential offered in that market without taking on all the downside risk.** In my memo *What Really Matters?* (November 2022), I said the key characteristic of superior investing is asymmetry – having more upside than downside. Alpha enables exceptional investors to modify the probability distributions such that they are biased toward the positive, resulting in superior risk-adjusted returns.



If alpha is the ability to earn return without taking fully commensurate risk, investors possessing it can do so by either reducing risk while giving up less return or by increasing potential return with a less-than-commensurate increase in risk. In other words, skill can enable some investors to outperform by emphasizing aggressiveness and some by emphasizing defensiveness. The choice between these approaches depends on the type of alpha an investor possesses: Is it the ability to produce stunning returns with tolerable risk, or the ability to produce good returns with minimal risk? Almost no investors possess both forms of alpha, and most possess neither. **Investors who lack alpha shouldn't expect to be able to produce either version of asymmetry – that is, to be able to generate superior risk-adjusted returns. However, most believe they do have it.**

The proper choice between the two approaches – **fewer losers or more winners** – depends on each investor's skill, return aspiration, and risk tolerance. As with many of the things I discuss, there's no right answer here. Just a choice.

September 12, 2023

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Memo to: Oaktree Clients

From: Howard Marks

Re: Further Thoughts on *Sea Change*

In May, I wrote a follow-up memo to Sea Change *(December 2022) that was shared exclusively with Oaktree clients. In* Further Thoughts on Sea Change*, I argued that the trends I had highlighted in the original memo collectively represented a sweeping alteration of the investment environment that called for significant capital reallocation. This memo was originally sent to Oaktree clients on May 30, 2023.*[1]

This Time It Really Might Be Different

On October 11, 1987, I first came across the saying "this time it's different." According to an article in *The New York Times* by Anise C. Wallace, Sir John Templeton had warned that when investors say times are different, it's usually in an effort to rationalize valuations that appear high relative to history – and it's usually done to investors' ultimate detriment. In 1987, it was high equity prices in general; the article I cite was written just eight days before Black Monday, when the Dow Jones Industrial Average declined by 22.6% in a single day. A dozen years later, the new thing people were excited about was the prospect that the Internet would change the world. This belief served to justify ultra-high prices (and p/e ratios of infinity) for digital and e-commerce stocks, many of which went on to lose more than 90% of their value over the next year or so.

Importantly, however, Templeton allowed that things might really be different 20% of the time. On rare occasions, something fundamental does change, with significant implications for investing. Given the pace of developments these days – especially in technology – I imagine things might genuinely be different more often than they were in Templeton's day.

Anyway, that's all preamble. My reason for writing this memo is that, while most people I speak with seem to agree with many of my individual observations in *Sea Change*, few have expressly agreed with my overall conclusion and said, "I think you're right: We might be seeing a significant and possibly lasting change in the investment environment." **This memo's main message is that the changes I described in *Sea Change* aren't just usual cyclical fluctuations; rather, taken together, they represent a sweeping alteration of the investment environment, calling for significant capital reallocation.**

The Backdrop

I'll start off by recapping my basic arguments from *Sea Change*:

- In late 2008, the Federal Reserve took the fed funds rate to zero for the first time ever in order to rescue the economy from the effects of the Global Financial Crisis.

[1] All market data cited in this memo is as of May 30, 2023.

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- Since that didn't cause inflation to rise from its sub-2% level, the Fed felt comfortable maintaining accommodative policies – low interest rates and quantitative easing – for essentially all of the next 13 years.
- As a result, we had the longest economic recovery on record – exceeding ten years – and "easy times" for businesses seeking to earn profits and secure financing. Even money-losing businesses had little trouble going public, obtaining loans, and avoiding default and bankruptcy.
- The low interest rates that prevailed in 2009-21 made it a great time for asset owners – lower discount rates make future cash flows more valuable – and for borrowers. This in turn made asset owners complacent and potential buyers eager. And FOMO became most people's main concern. The period was correspondingly challenging for bargain hunters and lenders.
- The massive Covid-19 relief measures – combined with supply-chain snags – resulted in too much money chasing too few goods, the classic condition for rising inflation.
- The higher inflation that arose in 2021 persisted into 2022, forcing the Fed to discontinue its accommodative stance. Thus, the Fed raised interest rates dramatically – its fastest tightening cycle in four decades – and ended QE.
- For a number of reasons, ultra-low or declining interest rates are unlikely to be the norm in the decade ahead.
- Thus, we're likely to see tougher times for corporate profits, for asset appreciation, for borrowing, and for avoiding default.
- Bottom line: If this really is a sea change – meaning the investment environment has been fundamentally altered – you shouldn't assume the investment strategies that have served you best since 2009 will do so in the years ahead.

Having supplied this summary, I'm going to put flesh on these bones and share some additional insights.

A Momentous Development

To promote discussion these days, I often start by asking people, "What do you consider to have been the most important event in the financial world in recent decades?" Some suggest the Global Financial Crisis and bankruptcy of Lehman Brothers, some the bursting of the tech bubble, and some the Fed/government response to the pandemic-related woes. No one cites my candidate: the 2,000-basis-point decline in interest rates between 1980 and 2020. And yet, as I wrote in *Sea Change,* that decline was probably responsible for the lion's share of investment profits made over that period. How could it be overlooked?

First, I suggest the metaphor of boiling a frog. It's said that if you put a frog in a pot of boiling water, it'll jump out. But if you put it in cool water and turn on the stove, it'll just sit there, oblivious, until it boils to death. The frog doesn't detect the danger – just as people fail to perceive the significance of the interest rate decline – because of its gradual, long-term nature. It's not an abrupt development, but rather a drawn out, highly influential trend.

Second, in *Sea Change*, I compared the 40-year interest rate decline to the moving walkway at an airport. If you stand still on the walkway, you'll move effortlessly; but, if you walk at your normal pace, you'll move ahead rapidly – perhaps without being fully conscious of why. In fact, if everyone's walking on the moving walkway, doing so can easily go unnoted, and the walkers might conclude that their rapid progress is "normal."

Finally, there's what John Kenneth Galbraith called "the extreme brevity of the financial memory." Relatively few investors today are old enough to remember a time when interest rates behaved differently. **<u>Everyone who has come into the business since 1980 – in other words, the vast majority of today's</u>**

investors – has, with relatively few exceptions, only seen interest rates that were either declining or ultra-low (or both). You have to have been working for more than 43 years, and thus be over 65, to have seen a prolonged period that was otherwise. And since market conditions made it tough to find employment in our industry in the 1970s, you probably had to get your first job in the 1960s (like me) to have seen interest rates that were either higher and stable or rising. I believe the scarcity of veterans from the '70s has made it easy for people to conclude that the interest rate trends of 2009-21 were normal.

The Relevance of History

The 13-year period from the beginning of 2009 through the end of 2021 saw two rescues from financial crises, a generally favorable macro environment, aggressively accommodative central bank policies, a lack of inflation worries, ultra-low and declining interest rates, and generally uninterrupted investment gains. The question, of course, is whether investors should expect a continuation of those trends.

- Recent events have shown that the risk of rising inflation can't be ignored in perpetuity. Moreover, the reawakening of inflationary psychology will probably make central banks less likely to conclude that they can engage in continuous monetary stimulation without consequences.
- Thus, interest rates can't be counted on to stay "lower for longer" and produce perpetual prosperity, as many thought was the case in late 2020.
- Also in late 2020, Modern Monetary Theory was accepted by some as meaning deficits and national debt could be disregarded in countries "with control of their currencies." (We no longer hear anything about this notion.)

In *Sea Change*, I listed several reasons why I don't think interest rates are going back to that period's lows on a permanent basis, and I still find these arguments compelling. **In particular, I find it hard to believe the Fed doesn't think it erred by sticking with ultra-low interest rates for so long.**

As noted above, to fight the GFC, the Fed took the fed funds rate to roughly zero for the first time in late 2008. Macro conditions were frightening, as a vicious cycle capable of undermining the entire financial system appeared to be underway. For this reason, aggressive action was certainly called for. But I was shocked when I looked at the data and saw that the Fed kept the rate near zero for nearly seven years. Setting interest rates at zero is an emergency measure, and we certainly didn't have a continuous emergency through late 2015. To me, those sustained low rates stand out as a mistake not to be repeated.

Further, by 2017-18, with the fed funds rate around 1%, it had become clear to many that there wasn't room for the Fed to reduce rates if necessary to stimulate the economy during a recession. But when the Fed attempted to raise rates to create that room, it encountered pushback from investors (see the fourth quarter of 2018). I find it hard to believe the Fed would want to reimpose that limitation on its toolkit.

A recurring theme of mine is that, even though many people agree that free markets do the best job of allocating resources, we haven't had a free market in money in roughly the last two decades, a period of Fed activism. Instead, Fed policy has been accommodative almost the entire time, and interest rates have been kept artificially low. Rather than letting economic and market forces determine the rate of interest, the Fed has been unusually active in setting interest rates, greatly influencing the economy and the markets.

Importantly, this distorts the behavior of economic and market participants. It causes things to be built that otherwise wouldn't have been built, investments to be made that otherwise wouldn't have

been made, and risks to be borne that otherwise wouldn't have been accepted. There's no doubt that this is true in general, and I'm convinced it accurately describes the period in question.

Many articles about the problems at Silicon Valley Bank and First Republic Bank cite errors that were made in the preceding "easy-money" period. Rapid growth, unwise inducements to customers, and lax financial management were all encouraged in a climate with accommodative Fed policy, uniformly positive expectations, and low levels of risk aversion. This is just one example of a time-worn adage in action: "The worst of loans are made in the best of times." I don't think the Fed should return us to an environment that has been distorted to encourage universal optimism, belief in the existence of a Fed put, and thus a dearth of prudence.

If the declining and/or ultra-low interest rates of the easy-money period aren't going to be the rule in the years ahead, numerous consequences seem probable:

- economic growth may be slower;
- profit margins may erode;
- default rates may head higher;
- asset appreciation may not be as reliable;
- the cost of borrowing won't trend downward consistently (though interest rates raised to fight inflation likely will be permitted to recede somewhat once inflation eases);
- investor psychology may not be as uniformly positive; and
- businesses may not find it as easy to obtain financing.

In other words, after a long period when everything was unusually easy in the world of investing, something closer to normalcy is likely to set in.

Please note that I'm not saying interest rates, having declined by 2,000 basis points over the last 40 or so years, are going back up to the levels seen in the 1980s. In fact, I see no reason why short-term interest rates five years from now should be appreciably higher than they are today. But still, I think the easy times – and easy money – are largely over. How can I best communicate what I'm talking about? Try this: **Five years ago, an investor went to the bank for a loan, and the banker said, "We'll give you $800 million at 5%." Now the loan has to be refinanced, and the banker says, "We'll give you $500 million at 8%." That means the investor's cost of capital is up, his net return on the investment is down (or negative), and he has a $300 million hole to fill.**

<u>What Strategies Will Work Best?</u>

It seems obvious that if certain strategies were the best performers in a period with a given set of characteristics, it must be true that a starkly different environment will produce a dramatically altered list of winners.

- As mentioned above in the recap of *Sea Change*, the 40 years of low and declining interest rates were hugely beneficial for asset owners. Declining discount rates and the associated reduction in the competitiveness of bond returns led to substantial asset appreciation. Thus, asset ownership – whether related to companies, pieces of companies (equities), or properties – was the place to be.
- Falling interest rates brought down the cost of capital for borrowers. As this occurred, any borrowing automatically became more successful than originally contemplated.
- And, as I also mentioned in *Sea Change*, the combined result of the above for investors who bought assets on borrowed money was a double bonanza. Think back to the first of the sea

changes I mentioned in that memo: the advent of high yield bonds in 1977-78, which brought about the trend toward bearing risk for profit and the emergence of levered investment strategies. **It's very notable that almost the entire history of levered investment strategies has been written during a period of declining and/or ultra-low interest rates.** For example, I would venture that nearly 100% of capital for private equity investing has been put to work since interest rates began their downward move in 1980. **Should it come as a surprise that levered investing thrived in such salutary conditions?**

- At the same time, declining interest rates rendered lending – or buying debt instruments – less rewarding. Not only were prospective returns on debt low throughout the period, but investors who were eager to get away from the ultra-low yields on safer securities like Treasurys and investment grade corporates competed spiritedly to deploy capital in higher-risk markets, and this caused many to accept lower returns and reduced lender protections.
- Finally, conditions in those halcyon days created tough times for bargain hunters. Where do the greatest bargains come from? The answer: the desperation of panicked holders. When times are untroubled, asset owners are complacent, and buyers are eager, no one has any urgency to exit, making it very hard to score significant bargains.

Investors who profited in this period from asset ownership and levered investment strategies may overlook the salutary effect of interest rates on asset values and borrowing costs and instead think the profits stemmed from the inherent merit of their strategies, perhaps with some help from their own skill and wisdom. That is, they may have violated a basic rule in investing: "Never confuse brains and a bull market." Given the benefits of being on the "moving walkway" during this period, it seems to me it would have required really bad decision-making or really bad luck for a purchase of assets made with borrowed money to have been unsuccessful.

Will asset ownership be as profitable in the years ahead as in the 2009-21 period? Will leverage add as much to returns if interest rates don't decline over time or if the cost of borrowing isn't much below the expected rate of return on the assets purchased? Whatever the intrinsic merits of asset ownership and levered investment, one would think the benefits will be reduced in the years ahead. And merely riding positive trends by buying and levering may no longer be sufficient to produce success. In the new environment, earning exceptional returns will likely once again require skill in making bargain purchases and, in control strategies, adding value to the assets owned.

Lending, credit, or fixed income investing should be correspondingly better off. As I mentioned in my December memo, the 13 years in question were a difficult, dreary, low-return period for credit investors, including Oaktree. Most of the asset classes we operate in were offering the lowest prospective returns any of us had ever seen. The options were to (a) hold and accept the new lower returns, (b) reduce risk to prepare for the correction that the demand for higher returns would eventually bring, or (c) increase risk in pursuit of higher returns. Obviously, all of these had drawbacks. The bottom line was that it was quite challenging to safely and dependably pursue high returns in a low-return world like the one we were experiencing.

But now, higher prospective returns are here. In early 2022, high yield bonds (for example) yielded in the 4% range – not a very useful return. Today, they yield more than 8%, meaning these bonds have the potential to make a great contribution to portfolio results. The same is generally true across the entire spectrum of non-investment grade credit.

Asset Allocation Today

My thinking about the sea change materialized mostly as I was visiting clients last October and November. When I got home, I wrote the memo and began to discuss its thesis. And at the December meeting of a non-profit investment committee, I said the following:

> Sell off the big stocks, the small stocks, the value stocks, the growth stocks, the U.S. stocks, and the foreign stocks. Sell the private equity along with the public equity, the real estate, the hedge funds, and the venture capital. Sell it all and put the proceeds into high yield bonds at 9%.

This institution needs to earn an annual return of 6% or so on its endowment, and I'm convinced that if it holds a competently assembled portfolio of 9% high yield bonds, it would be overwhelmingly likely to exceed that 6% target. But mine wasn't a serious suggestion, more a statement designed to evoke discussion of the fact that, **thanks to the changes over the last year and a half, investors today can get equity-like returns from investments in credit.**

The Standard & Poor's 500 Index has returned just over 10% per year for almost a century, and everyone's very happy (10% a year for 100 years turns $1 into almost $14,000). Nowadays, the ICE BofA U.S. High Yield Constrained Index offers a yield of over 8.5%, the CS Leveraged Loan Index offers roughly 10.0%, and private loans offer considerably more. **In other words, expected pre-tax yields from non-investment grade debt investments now approach or exceed the historical returns from equity.**

And, importantly, these are contractual returns. When I shifted from equities to bonds in 1978, I was struck by a major difference. With equities, the bulk of your return in the short or medium term depends on the behavior of the market. If Mr. Market's in a good mood, as Ben Graham put it, your return will benefit, and vice versa. With credit instruments, on the other hand, your return comes overwhelmingly from the contract between you and the borrowers. You give a borrower money up front; they pay you interest every six months; and they give you your money back at the end. And, to greatly oversimplify, if the borrower doesn't pay you as promised, you and the other creditors get ownership of the company via the bankruptcy process, a possibility that gives the borrower a lot of incentive to honor the contract. The credit investor isn't dependent on the market for returns; if the market shuts down or becomes illiquid, the return for the long-term holder is unaffected. The difference between the sources of return on stocks and bonds is profound, something many investors may understand intellectually but not fully appreciate.

It's been years since prospective returns on credit were competitive with those on equities. Now it's the case again. Should the non-profit whose board I sit on put all its money into credit instruments? Perhaps not. But Charlie Munger exhorts us to "invert," or flip questions like this. **To me, this means allocators should ask themselves, "What are the arguments for not putting a significant portion of our capital into credit today?"**

Here I'll mention that, over the years, I've seen institutional investors pay lip service to developments in markets and make modest changes in their asset allocation in response. When the early index funds outperformed active management in the 1980s, they said, "We've got that covered: We've moved 2% of our equities to an index fund." When emerging markets look attractive, the response is often to move another 2%. And from time to time, a client tells me they've put 2% in gold. **But if the developments I describe really constitute a sea change as I believe – fundamental, significant, and potentially long-lasting – credit instruments should probably represent a substantial portion of portfolios . . . perhaps the majority.**

What's the downside? How could this be a mistake?

- First, individual borrowers can default and fail to pay. It's the main job of the credit manager to weed out the non-payers, and history shows it can be done. Isolated defaults are unlikely to derail a well-selected and well-diversified portfolio. And if you're worried about a wave of defaults hitting your credit portfolio, think about what the implications of that environment would be for equities or other ownership assets.
- Second, by their nature, credit instruments don't have much potential for appreciation. Thus, it's entirely possible that equities and levered investment strategies will surprise on the upside and outperform in the years ahead. There's no denying this, but it should be borne in mind that the "downside risk" here consists of the opportunity cost of returns forgone, not failing to achieve the return one sought.
- Third, bonds and loans are subject to price fluctuations, meaning having to sell in a weak period could cause losses to be realized. But credit instruments are far from alone in this regard, and the magnitude of the fluctuations on "money-good" bonds and loans is constrained significantly by the magnetic "pull to par" exerted by the promise of repayment upon maturity.
- Fourth, the returns I've been talking about are nominal returns. If inflation isn't brought under control, those nominal returns could lose significant value when they're converted into real returns, which are what some investors care about most. Of course, real returns on other investments could suffer as well. Many people think of stocks and real estate as potentially providing inflation protection, but my recollection from the 1970s is that the protection typically takes hold <u>only after</u> prices have declined so as to provide higher prospective returns.
- Finally, the sea change could end up being less long-lasting than I expect, meaning the Fed takes the fed funds rate back down to zero or 1% and the yields on credit recede accordingly. Fortunately, by buying multi-year credit instruments, an investor can tie up the promised return for a meaningful period (assuming the investment provides some degree of call protection). Reinvesting will have to be dealt with upon maturity or call, but once you've made the credit investments I'm suggesting, you will at least have secured the promised yield – perhaps minus losses on defaults – for the term of the instruments.

* * *

<u>The overarching theme of my sea-change thinking is that, largely thanks to highly accommodative monetary policy, we went through unusually easy times in a number of important regards over a prolonged period, but that time is over.</u> There clearly isn't much room for interest rate declines from today's levels, and I don't think short-term interest rates will be as low in the coming years as in the recent past. For these and other reasons, I believe the years ahead won't be as easy. But while my expectations may prove correct, there's no evidence yet on which I can hang my hat. Why not? My answer is that the economy and markets are in the early stages of a transition that's far from complete.

Asset prices are established through a tug-of-war between buyers who think prices will rise and sellers who think they'll fall. There's been an active one over the last year or so as sentiment has waxed and waned regarding the outlook for inflation, recession, corporate profits, geopolitics, and especially a Fed pivot back to accommodation. The tug-of-war is ongoing, and, as a result, the S&P 500 is within a half percent of where it was a year ago.

I've been thinking lately about the fact that being an investor requires a person to be somewhat of an optimist. Investors have to believe things will work out and that their skill will enable them to wisely position capital for the future. Equity investors have to be particularly optimistic, as they have to believe someone will come along who'll buy their shares for more than they paid. **My point here is that optimists surrender their optimism only grudgingly**, and phenomena such as cognitive dissonance and self-delusion permit opinions to be held long after information to the contrary has arrived. This is among the reasons why they say of the stock market: "Things can take longer to happen than you thought they would, but then they happen faster than you thought they could." Today's sideways or "range-bound" market tells me investors possess a good amount of optimism despite the worries that have arisen. In the coming months, we'll find out if the optimism was warranted.

The positive forces that shaped the 2009-21 period began to change around 18 months ago. The higher inflation turned out not to be transitory. This brought on interest rate increases, concern that a recession would result, some resurrection of worry over the possibility of loss, and thus insistence on greater compensation for bearing risk. But while most people no longer see an outlook that's flawless, few think it's hopeless either. **Just as optimism abetted a positive cycle in those 13 years, I believe a lessening of optimism will throw some sand into the financial gears in a variety of ways, some of which may be unforeseeable.**

In this latter regard, it's essential to acknowledge that since we haven't lived through times exactly like the years that lie ahead – and since changes in the economic/financial environment limit the applicability of history – we're likely to encounter surprises. And if the environment is less favorable, the surprises are likely to be on the downside.

Please note, as mentioned earlier, that I'm absolutely not saying interest rates are going back to the high levels from which they've come. I have no reason to believe that the recession most people believe lies ahead will be severe or long-lasting. And with valuations high, but not terribly so, I don't think a stock market collapse can reasonably be predicted. This isn't a call for dramatically increased defensiveness. Mostly I'm just talking about a reallocation of capital, away from ownership and leverage and toward lending.

This isn't a song I've sung often over the course of my career. This is the first sea change I've remarked on and one of the few calls I've made for substantially increasing investment in credit. **But the bottom line I keep going back to is that credit investors can access returns today that:**

- **are highly competitive versus the historical returns on equities,**
- **exceed many investors' required returns or actuarial assumptions, and**
- **are much less uncertain than equity returns.**

Unless there are serious holes in my logic, I believe significant reallocation of capital toward credit is warranted.

October 11, 2023

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Memo to: Oaktree Clients

From: Howard Marks

Re: Easy Money

The backstory: I began writing these memos in 1990 and continued to do so for ten years despite never receiving a single response. Then, on the first business day of 2000, I published bubble.com, a memo with warnings about excesses in the tech sector that turned out to be timely. The inspiration for the memo came from a book I'd read the preceding autumn: Devil Take the Hindmost: A History of Financial Speculation, by Edward Chancellor, an account of speculative excesses starting with the South Sea Bubble of the early 1700s. The book's description of behavior surrounding the mania for the South Sea Company jibed with what I was seeing in the tech/media/telecom bubble that was underway. I received excellent feedback on the memo from clients – encouragement that prompted the many memos that have followed.

I consider it highly coincidental that 24 years later, I devoted another autumn to reading another Chancellor book, The Price of Time: The Real Story of Interest, his history of interest rates and central bank behavior. I thank Zach Kessler, a regular memo reader, for sending it. The relevance of The Price of Time to the trends I've been discussing for the last year occasions this memo.

* * *

In December 2022, I published *Sea Change*, a memo that primarily discussed the 13-year period from the end of 2008, when the U.S. Federal Reserve cut the fed funds rate to zero to counter the effects of the Global Financial Crisis, to the end of 2021, when the Fed abandoned the idea that inflation was transitory and readied what turned out to be a rapid-fire succession of interest rate increases. The memo concentrated on the impact that this lengthy period of unusually low interest rates had on the economy, the financial markets, and investment outcomes. I followed this up with the memo *Further Thoughts on Sea Change*, which Oaktree released to clients in May 2023 and to the public in October. In the latter memo and subsequent conversations with clients, I've emphasized the significant impact of low interest rates on the behavior of participants in the economy and the markets.

Easy Times

In *Sea Change*, I likened the effect of low interest rates to the moving walkway at the airport. If you walk while on it, you move ahead faster than you would on solid ground. But you mustn't attribute this rapid pace to your physical fitness and overlook the contribution from the walkway.

In much the same way, declining and ultra-low interest rates had a huge but underrated influence on the period in question. They made it:

- easy to run a business, with the stimulated economy growing unabated for more than a decade;
- easy for investors to enjoy asset appreciation;

- easy and cheap to lever investments;
- easy and cheap for businesses to obtain financing; and
- easy to avoid default and bankruptcy.

In short, these were easy times, fueled by easy money. Like travelers on the moving walkway, it was easy for businesspeople and investors to think they were doing a great job all on their own. In particular, market participants got a lot of help in this period as they rode the 10-year-plus bull market, the longest in U.S. history. Many disregarded the benefits that ensued from low interest rates. But as one of the oldest investment adages says, we should never confuse brains with a bull market.

As I've continued to think and talk about the switch from declining and/or ultra-low interest rates to more normal, stable ones, I've emphasized the fact that low rates alter investor behavior, distorting it in ways that have serious consequences.

Thinking about the change in interest rates sensitized me to media mentions of low rates, and I've noticed many. This was particularly true following Silicon Valley Bank's meltdown last March, which many articles attributed to faulty managerial decisions made "during the preceding period of easy money." More recently, there's been much discussion of the less-favorable outlook for private equity, usually related to expectations that interest rates aren't going to return to the low levels of the recent past.

The effects of low interest rates are multi-faceted and ubiquitous, yet frequently overlooked. I became more conscious of them as I read *The Price of Time*, and I want to catalog them here:

i. <u>Low interest rates stimulate the economy</u>

Everyone knows that when central banks want to stimulate their countries' economies, they cut interest rates. Lower rates reduce costs for businesses and put money into the hands of consumers. For example, since most people buy cars on credit or lease them, lower interest rates make cars more affordable, increasing demand. The result is typically good for automakers, their suppliers, and their workers, and thus for the economy in general.

It's important to realize that easy money keeps the economy aloft, at least temporarily. **But low interest rates can make the economy grow too fast, bringing on higher inflation and increasing the probability that rates will have to be raised to fight it, discouraging further economic activity.** This oscillation of interest rates between extremes can have effects and encourage behavior that natural/neutral rates (see p. 13) would be less likely to induce.

ii. <u>Low interest rates reduce perceived opportunity costs</u>

Opportunity cost is a major consideration in most financial decisions. But in low-interest-rate environments, the rate earned on cash balances is minimal. Thus, you don't forgo much interest by withdrawing money from the bank to buy a house or boat (or make an investment), which makes doing so seem painless. For example, if someone's thinking about taking $1 million out of savings for a purchase at a time when savings accounts pay 5% interest, they're likely to understand that doing so will cost them $50,000 per year in forgone income. **But when the rate is zero, there is no opportunity cost. This makes the transaction more likely to occur.**

iii. <u>Low interest rates lift asset prices</u>

In finance theory, the value of an asset is defined as the discounted present value of its future cash flows. We discount future cash flows when calculating present value because we must wait to receive them, so they're less valuable than cash flows received today. The lower the rate at which future cash flows are discounted, the higher the present value, as investors have noted for centuries:

> In the [18th] century, Adam Smith described how the price of land depended on the market rate of interest. In *The Wealth of Nations* (published in 1776) Smith noted that land prices had risen in recent decades, as interest rates declined. (*The Price of Time, or "TPOT"*)
>
> By placing too low a discount on the future earnings of companies, investors [in the 1920s] ended up paying too much. (*TPOT*)

In real life, investments are evaluated primarily on a relative basis. The return demanded on each investment is largely a function of the prospective returns on other investments and differences in these investments' respective levels of risk. **Low interest rates lower the "relative bar," making the higher returns offered on riskier assets appear relatively attractive even if they're low in the absolute.**

In this vein, *The Price of Time* describes the thought process that made "iffy" loans to the government of Argentina acceptable in the low-rate environment of the late 1880s:

> Buenos Aires "took advantage of the low rate of interest and the abundance of money in Europe to contract as many loans as possible, new loans often being made in order to pay the interest on former ones." Some Argentine loans paid as little as 5 percent – **low in absolute terms or relative to their risk but still a couple of points above the measly yield on [consols, or perpetual British government debt]** . . . (*TPOT*, emphasis added)

When bond yields decline, bonds present less competition for riskier assets. Thus, low yields on bonds lead to lower demanded returns – and higher valuations – on other asset classes, such as equities, real estate, and private equity. **For these reasons, low interest rates lead to asset inflation and sometimes asset bubbles like those we saw in late 2020 and throughout 2021.**

iv. <u>Low interest rates encourage risk taking, leading to potentially unwise investments</u>

Low interest rates create a "low-return world" marked by paltry prospective returns on safe investments. At the same time, investors' required returns or desired returns typically don't decline (or they decline by much less), meaning investors face a shortfall. **The ultra-low returns on safe assets cause some investors to take additional risks to access higher returns. Thus, these investors become what my late father-in-law called "handcuff volunteers" – they move further out on the risk curve not because they want to, but because they believe it's the only way to achieve the returns they seek.**

In this way, capital moves out of low-return, safe assets and in the direction of riskier opportunities, resulting in strong demand for the latter and rising asset prices. Riskier investments perform well for a while under these conditions, encouraging further risk taking and speculation:

> In his 1844 book *On the Regulation of Currencies* [banker John Fullarton] observed that at times of low interest, "everything in the nature of value puts on an aspect of bloated magnitude," and every article becomes an object of

> speculation. Long periods of easy money, wrote Fullarton, engender "a wild spirit of speculation and adventure." Fullarton noted that financial euphoria occurred after a period of falling interest rates: "From the Bubble year [i.e., the South Sea Bubble of 1720] downwards, I question much if an instance could be shown of any great or concurrent speculative movement on the part of capitalists, which had not been preceded by a marked decline of the current rate of interest." (*TPOT*)

The risk-free rate is the point of origin, or jumping-off point, for returns and risk premia. When a central bank cuts the risk-free rate:

- the rest of the yield curve usually follows;
- the capital market line governing asset-class returns also shifts downward, especially if the desire for higher returns in the low-return environment causes riskier investments to be aggressively pursued as described above;
- in addition to moving lower, the capital market line also can flatten, reducing risk premia, if investors are paying little heed to fundamental/credit risk; and
- the liquidity premium – the increment in expected return for owning illiquid rather than readily saleable assets – can also shrink, as return-seeking investors embrace illiquid investments.

In all these ways, the return increments associated with longer-term, riskier, or less-liquid assets can become inadequate to fully compensate for the increase in risk. Nevertheless, the low prospective returns on safe securities cause investors to look past these factors and lower their standards, encouraging speculation and causing questionable investments to be made in pursuit of higher returns:

> For [Austrian-school economist Friedrich] Hayek, it was axiomatic, but all too often overlooked, that "all economic activity is carried out through time." When interest rates decline, he said, businesses are inclined to invest in projects with more distant payoffs – in Hayek's terminology, the "structure of production" lengthens. If interest rates are kept below their natural level [see p. 13], misguided investments occur: too much time is used in production, or, put another way, the investment returns don't justify the initial outlay. **"Malinvestment", to use a term popularized by Austrian economists, comes in many shapes and sizes. It might involve some expensive white-elephant project, such as constructing a tunnel under the sea, or a pie-in-the-sky technology scheme with no serious prospect of ever turning a profit.** (*TPOT*, emphasis added; the quotation is from 1928)

I'll provide a few examples of imprudent investments made during the recent easy money period:

- In the low-return environment of 2017, Argentina once again became the poster child for questionable investment opportunities, when it offered 100-year bonds. As I asked at the time in my memo *There They Go Again . . . Again* (July 2017), "Is Argentina, a country that defaulted five times in the last hundred years (and once in the last five), likely to get through the next hundred without a rerun?" Argentina's checkered history as a borrower was ignored in the low-return environment, and the bonds were oversubscribed thanks to their having a yield of 7.85% at a time when 30-year Treasurys offered only 2.77%. It took less than a year for Argentina to request a loan from the International Monetary

Fund and less than three years for it to default on the bonds. When the 100-year bonds were restructured in 2020, holders received new bonds with an expected recovery value of roughly 54.5 cents on the dollar, according to *The Wall Street Journal* of August 31, 2020. Aptly, that same *Journal* article quoted Piotr Matys of Rabobank Group NV, as saying, **"Treasury yields are so low, it's forcing investors into risk. That's why people are buying crazy stuff."**

- In the 2010s, investors eagerly snapped up leveraged buyout loans bearing historically low yields of around 6%. The buyers included CLOs, which are structured to give relatively high yields to the investors in their lower-rated tranches, as well as private credit lenders that levered up the prospective returns to roughly 9%.
- While "zombie" companies that burn cash haven't historically been considered creditworthy, many were able to borrow easily in the pro-risk times through 2021. But as financial conditions have tightened, these companies have seen their cost to borrow rise and/or the amounts they can borrow shrink.
- The craving for good returns in low-return times can enable scams. Theranos (the medical technology company) and FTX (the cryptocurrency exchange) were the most prominent examples in recent years. Such scandals are less likely to happen in times of economic and capital market stringency, when investors are less eager and more careful.

Under easy-money conditions, long-dated bonds may appear particularly desirable; since the yield curve usually slopes upward, they typically offer higher yields. It should be noted, however, that long bonds are more rate-sensitive than short ones, meaning their prices change more in response to a given change in interest rates. As a result, the higher yields on more-volatile long bonds can attract capital in times of low rates, just when the odds usually favor a subsequent increase in yields (and thus a rapid decline in long bond prices).

It seems to me that there's often a similar movement of capital toward "long stocks" when interest rates are low. By this I mean the stocks of companies believed to have many years of rapid growth ahead. For these companies, more of the projected cash flows are, by definition, in the distant future. Yet, investors may become more attracted to these stocks when rates are low because they want the higher returns that such rapid growth would bring, and there's less opportunity cost associated with the long wait for the relevant cash flows. (These sound like Hayek's "projects with more distant payoffs." See the quote on the previous page.) Just as the prices of longer bonds fluctuate more in response to a given change in interest rates, so-called "growth stocks" usually rise more than others in times of easy money and fall more when money dries up. The former was certainly the case in late 2020 and in 2021 . . . and the latter in 2022.

I love Hayek's word "malinvestment," because of the validity of the idea behind it: in low-return times, investments are made that shouldn't be made; buildings are built that shouldn't be built; and risks are borne that shouldn't be borne. People with money feel they must put it to work, since cash yields little or nothing. They drop their risk aversion and, as discussed below, compete spiritedly for lending or investing opportunities with higher potential returns. **The investment process becomes all about flexibility and aggressiveness, rather than thorough diligence, high standards, and appropriate risk aversion.**

Skimpy return prospects on safe assets lead to elevated risk taking – sometimes abetted by widespread optimism and/or the suspension of disbelief – and thus to the approval of investments that would likely be greeted with skepticism in normal times. Many of the risky assets people invest in out of presumed necessity are deemed less palatable and less valuable under tougher market conditions, when they can only be sold at lower prices.

v. Low rates enable deals to be financed readily and cheaply

Related to the above, low rates make people more willing to lend for risky propositions. Providers of capital vie to be the one who gets the deal. To compete for deals, the "winner" must be willing to accept low returns from possibly questionable projects and reduced safety, including weaker documentation. **For this reason, it's often said that "the worst of loans are made at the best of times."**

The availability of capital fluctuates radically. Whereas in times of stringency, capital may not be available even to quality borrowers for valid purposes, in periods of easy money, capital typically becomes available to weaker borrowers, in large amounts, for almost any purpose. Things that couldn't be financed in tighter times are deemed acceptable.

For one example, consider the shifting perception of high-tech companies. Prior to roughly 2005, they were usually considered too undependable to be creditworthy, since outcomes for tech investments are generally asymmetric. If the company succeeds, the equity owners get rich. If it fails, there's little asset value for creditors to recover. But in the years following the tech/media/telecom meltdown of 2000-02, when interest in public equities declined and large sums flooded into private equity funds, tech companies began to be bought out, often with financing from the newly popular field of private credit.

vi. Low interest rates encourage greater use of leverage, increasing fragility

Borrowed money – leverage – is the mother's milk of rapid expansion and speculation. In my memo *It's All Good* (July 2007), I compared leverage to ketchup: "I was a picky eater when I was a kid, but I loved ketchup, and my pickiness could be overcome with ketchup." Ketchup got me to eat food I otherwise would have considered inedible. In much the same way, leverage can make otherwise unattractive investments investible. Let's say you're offered a low-rated loan yielding 6%. "No way," you say, "I'd never buy a security that risky at such a low yield." But what if you're told you can borrow the money to buy it at 4%? "Oh, that's a different story. I'll take all I can get." But it must be noted that cheap leverage doesn't make investments better; it merely amplifies the results.

In times of low interest rates, absolute prospective returns are low and leverage is cheap. Why not use a lot of leverage to increase expected returns? In the late 2010s, money flowed to both private equity, given its emphasis on leveraged returns from company ownership, and private credit, which primarily provides debt capital to private equity deals. These trends complemented each other and led to a significant upswing in levered investing.

But in the last decade, some companies acquired by private equity funds were saddled with capital structures that failed to anticipate the increase in interest rates of 400-500 basis-points. Having to pay interest at higher rates has reduced these companies' cash flows and interest coverage ratios. Thus, companies that took on as much debt as possible – based on their former levels of earnings and the prevailing low interest rates – may now be unable to service their debt or roll it over in a higher-rate environment.

Finally, all else being equal, the more leverage that's piled on a company, the lower the probability it'll be able to survive a rough patch. This is one of the foremost reasons for the adage "never forget the six-foot-tall man who drowned crossing the stream that was five feet deep on average." Heavy leverage can render companies fragile and make it hard for them to get through the proverbial low spots in the stream. Take, for example, Signa, a large privately owned property company in Europe, which announced in November of last year that it was beginning insolvency proceedings:

> **The decision to go all-out during the era of cheap money left Signa dangerously exposed to the sharp rise of interest rates this year. . . .** And rising interest rates have hammered commercial property values across the market, reducing the value of the assets used to secure Signa's loans. (*FT Asset Management Newsletter*, December 11, 2023, emphasis added)

vii. Low interest rates can lead to financial mismatches

Easy-money episodes make it particularly attractive to borrow short at low rates in order to make long-term investments or loans with higher prospective returns. This is the other classic reason why, in the investment world, proverbial six-footers often drown. (Investors with liability maturities that match the duration of their assets make it across the river much more regularly.) In tougher times, if lenders demand their money back or decline to roll over existing debt when it comes due, debtors can find themselves holding discounted or illiquid assets – just when cash is needed. This is a familiar theme that frequently marks the turn of the cycle from benign to nasty. Chancellor provides an example from 1866 in connection with the failure of Overend Gurney, a London broker:

> Lending against long dated and illiquid collateral was not a suitable business for Overend, which normally discounted three-month commercial paper financed with daily cash calls on the money market. *The Times* [*of London*] described how Overend had erred:
>
> > A Discount Company which had forsaken the business of discount brokers for that of "financing", which had locked up its assets in securities promising to repay a high rate of interest, but incapable of conversion into cash on an emergency, had found its resources too limited to meet the calls upon them except at a ruinous sacrifice of its property, and had, therefore, suspended payment. (*TPOT*)

viii. Low interest rates give rise to expectations of continued low rates

It's common for people to conclude that the environment they've lived through for a while is "normal," and that the future will entail more of the same. For this reason, people who have gotten used to low interest rates may think rates will always be low and make decisions based on that assumption. **As a result, investor due diligence or corporate planning may assume that the cost of capital will remain low. This can become a source of trouble if rates are higher when financing is actually sought.**

For example, in recent months, I've noted a number of lots in midtown Manhattan that have been cleared for the construction of new buildings. Given the lengthy planning and approval process involved with such projects, these buildings were undoubtedly greenlit in the low-interest-rate environment that preceded 2022. Will they be built if the actual financing costs are higher than those that were assumed? Or will they be abandoned at significant cost?

When the pandemic year of 2020 came to a close, the recovering economy, rallying stock market, and low interest rates put investors in a good mood, and there was widespread belief that the Fed would keep rates "lower for longer," supporting the economy and stock market for years to come.

However, investors learned a lesson that has been repeated throughout financial history: catalysts for interest rate increases inevitably pop up, and thus perpetual prosperity and "the end of cycles" turn out to be nothing but wishful thinking. Consider another example from Chancellor:

> One of the aims of U.S. monetary policy in the 1920s was to dampen the seasonal fluctuations of interest rates caused by the agricultural cycle, which led to money being tight at certain times of the year. The Fed was so successful at this that Treasury Secretary Andrew Mellon went so far as to hail an end to the cycle of boom and bust. "We are no longer the victim of the vagaries of business cycles. . . . As economist Perry Mehring writes [in *The New Lombard Street*]: **"Intervention to stabilize seasonal and cyclical fluctuations produced low and stable money rates of interest, which supported the investment boom that fueled the Roaring Twenties but also produced an unstable asset price bubble."** (*TPOT,* emphasis added)

ix. <u>Low interest rates bestow benefits and penalties, creating winners and losers</u>

Importantly, low interest rates subsidize borrowers at the expense of savers and lenders. Does it make sense to reduce the revenues of lenders so that investors can lever their investments cheaply?

> [In the mid-17th century,] Thomas Manley added that lowering the rate of interest would involve robbing Peter (the creditor) to pay Paul (the borrower). (*TPOT*)

Doing so is a policy decision, or more likely the consequence of a decision to stimulate the economy. But it can have many other effects.

When the rate of interest on savings is 4%, a retiree fortunate enough to have saved up $500,000 will earn $20,000 per year on her bank balance. But when the interest rate on a savings account is near zero, as we saw for much of the last 14 years, she gets essentially nothing. Is it good for society to make her settle for zero? Or would it be better if she put the money into the stock market in an effort to make more?

While discussing the ramifications of policy decisions, let's consider the impact of low rates on the distribution of income and wealth.

> **. . . because assets like stocks and real estate are disproportionately held by the rich, ZIRP [the "zero interest-rate policy" that was introduced in December 2008] helped produce the largest spike in wealth inequality in postwar American history.** From 2007 to 2019, . . . the wealthiest 1 percent of Americans saw their net worth increase by 46 percent, while the bottom half saw only an 8 percent increase. A report from McKinsey Global Institute, not exactly known as a bastion of economic populism, calculated that from 2007 to 2012, the Fed's policies created a benefit for corporate borrowers worth about $310 billion, whereas households that tried to save money were penalized by about $360 billion. (*The Atlantic*, December 11, 2023, emphasis added)

The yawning economic gap is one of the biggest problems the U.S. faces, and it's probably responsible for a fair bit of the extreme divisiveness we see every day in the media and in

politics. A central bank's decision to set rates that subsidize some and penalize others clearly has consequences.

x. Low rates induce optimistic behavior that lays the groundwork for the next crisis

Elevated risk taking, underestimating future financing costs, and increased use of leverage often lie behind investments that fail when tested in subsequent periods of stringency, bringing on the next crisis and perhaps the need for the next rescue. In this way, excesses in one direction typically precede excesses in the other direction.

> In October 1889, the Governor of the Bank of England, William Lidderdale, delivered a stern warning to the City:
>
> > The present tendency of finance . . . is distinctly in the direction of danger, too much capital is being forced into industrial developments, financiers are taking larger & larger risks in securities which require prosperity & easy money to carry without becoming a burden, & an increased number of investments have been driven up in price by the combined efforts of a long period of cheap money & depression in trade . . . we have most of the elements of a Crisis. (*TPOT*)

The Never-Ending Story

One of the quotes I return to most frequently is Mark Twain's purported observation that "history doesn't repeat itself, but it often rhymes." **For investors, cycles, along with their causes and effects, are among the influential matters that invariably rhyme from one period to the next.**

Roughly 30 years ago – largely thanks to my involvement with my partner Bruce Karsh and his distressed debt funds – I became much more conscious of the importance of fluctuations in the availability and cost of money. Thus, I wrote as follows in my memo *You Can't Predict. You Can Prepare.* (November 2002):

> The longer I'm involved in investing, the more impressed I am by the power of the credit cycle. It takes only a small fluctuation in the economy to produce a large fluctuation in the availability of credit, with great impact on asset prices and back on the economy itself.

I reused that paragraph in my 2018 book *Mastering the Market Cycle: Getting the Odds on Your Side*, adding this:

> . . . the credit cycle can be easily understood through the metaphor of a window. In short, sometimes it's open and sometimes it's closed. And, in fact, people in the financial world make frequent reference to just that: "the credit window," as in "the place you go to borrow money." When the window is open, financing is plentiful and easily obtained, and when it's closed, financing is scarce and hard to get. . . .

In the book I made three foundational observations about cycles in general:

- **The events that make up each cyclical progression don't merely follow each other. Much more importantly, each event in the progression is caused by those that went before.** This causality must be appreciated if one is to fully understand cycles and navigate them successfully.
- Cyclical oscillation isn't best thought of as consisting merely of "ups and downs," but rather as (a) an excessive departure from the midpoint, secular trend or norm in one direction, and (b) a correction of that excess, which often ends up in (c) an excessive continuation of the correction in the opposite direction. **"Excesses and corrections" is a much more useful way to think about cycles than "ups and downs."**
- Cycles don't have an obvious beginning and end. The only requirement for something to correctly be considered a full cycle is that it must include four components: (1) a movement from a norm to a high, (2) a move away from that high back toward the norm, (3) a move from the norm to a corresponding low, and (4) a movement from that low back toward the norm. **Any of these can be labeled the start of a cycle, providing it goes on to include all four.**

While there's no fixed point that represents the official start or end of a cycle, most economic cycles can be described as follows. Notably, each step in the cycle causes the next.

- **First, stimulative rate cuts bring on easy money and positive market developments;**
- **which reduce prospective returns;**
- **which leads to willingness to bear increased risk;**
- **which results in unwise decisions and, eventually, investment losses;**
- **which bring on a period of fear, stringency, tight money, and economic contraction;**
- **which leads to stimulative rate cuts, easy money, and positive market developments.**

Here's an especially trenchant observation on the cyclical process:

> The Manchester banker John Mills commented perceptively [in 1865] that **"as a rule, panics do not destroy capital; they merely reveal the extent to which it has previously been destroyed by its betrayal into hopelessly unproductive works."** (*TPOT,* emphasis added)

As readers know, I believe investors can gain an advantage by studying cycles, understanding their causes, and watching for excesses in one direction that are likely to lead to corrections in the opposite direction. Walter Bagehot, the editor of *The Economist* in the 1860s, is described as having demonstrated an exceptional understanding of cycles and cycle-related behavior:

> . . . our modern monetary mandarins never stop to consider Bagehot's warnings about the adverse consequences of easy money – how interest rates set at 2 per cent or less fuel speculative manias, drive savers to make risky investments, encourage bad lending and weaken the financial system. (*TPOT*)

What I so enjoy about Chancellor's books is the way they illustrate the tendency of financial history themes to rhyme, as Twain would say, and thus how behavior that took place 200 or 400 years ago is being repeated today and is sure to reappear again and again in the future. What he tells is a never-ending story.

Easy Money Observed

The behavior brought on by low rates takes place in plain sight. Some people take note of it, and a subset of them talk about it rather than let it pass unremarked. Fewer still understand its real implications. **And almost no one alters their investment approach to take them into account.**

The low-rate period that immediately preceded the Global Financial Crisis of 2008-09 was marked by the kind of spirited competition to make investments and provide financing described above. It was in this climate that Chuck Prince, then CEO of Citi, made the statement for which he is remembered:

> When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. (July 14, 2007)

When money is easy, few people opt to sit out the dance, even though the adverse results described above can reasonably be anticipated. When faced with the choice between (a) maintaining high standards and missing deals and (b) making risky investments, most people will choose the latter. Professional investment managers especially may fear the consequences of idiosyncratic behavior that's bound to look wrong for a while. **Abstaining demands uncommon strength when doing so means departing from herd behavior.**

And this gives me a great opportunity to reference one of my favorite quotations from John Kenneth Galbraith's wonderful book on market excesses:

> Contributing to and supporting this 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. . . . There can be few fields of human endeavor in which history counts for so little as in the world of finance. (*A Short History of Financial Euphoria*)

The lessons from past periods of easy money usually fall on deaf ears since they come up against (a) ignorance of history, (b) the dream of profit, (c) the fear of missing out, and (d) the ability of cognitive dissonance to make people dismiss information that is inconsistent with their beliefs or perceived self-interest. These things are invariably enough to discourage prudence in times of low interest rates, despite the likely consequences.

As you no doubt know, Charlie Munger passed away on November 28 at the age of 99. I want to pay a small tribute to Charlie's life and wisdom by sharing something he wrote me in 2001: "Maybe we have a new version of Lord Acton's law: easy money corrupts, and really easy money corrupts absolutely."

Will We Go Back to Easy Money?

Before I turn to the above question, I want to answer the one I'm asked most often these days: "Are you saying interest rates are going to be higher for longer?" My answer is that today's rates aren't high. They're higher than we've seen in 20 years, but they're not high in the absolute or relative to history. Rather, I consider them normal or even on the low side.

- In 1969, the year I started work, the fed funds rate averaged 8.2%.
- Over the next 20 years, it ranged from 4% to 20%. Given this range, I certainly wouldn't describe 5.25-5.50% as high.

- Between 1990 and 2000, which I would consider the last roughly normal period for rates, the fed funds rate ranged from 3% to 8%, suggesting a median equal to today's 5.25-5.50%.

So no, today's interest rates aren't high. Having disposed of that question, I'll move to the subject of this section: the outlook for rates.

Many of my reasons for believing we're not going back to ultra-low rates are rooted in my thoughts on how the Fed <u>should</u> think about the issue. But the Fed could decide to lower rates to stimulate economic growth or reduce the cost of servicing the national debt, even if doing so might be deemed imprudent. Thus, I have no idea what the Fed <u>will</u> do. But I'm sticking with the thinking that follows.

In my original *Sea Change* memo, I listed a number of reasons why we weren't likely to go back to ultra-low interest rates anytime soon. The most salient are these:

- Globalization has been a strong disinflationary influence, and it's likely on the decline. For this reason – and because the bargaining power of labor seems to be on the rise – I believe inflation may tend to be higher in the near future than it was pre-2021. If true, this will, all else being equal, mean interest rates will be kept higher to prevent inflation from accelerating.
- Rather than be in a perpetually stimulative posture, the Fed may want to maintain the neutral rate most of the time. This rate, which is neither stimulative nor restrictive, has most recently been estimated to be 2.5%.
- The Fed might want to get out of the business of controlling rates and let supply and demand set the price of money, which hasn't been the case for a quarter century.
- Having had a taste of inflation for the first time in decades, the Fed might keep the fed funds rate high enough to avoid encouraging another bout. To control inflation, one would think the rate would need to be kept positive in real terms. If inflation will be, say, 2.5%, the fed funds rate would by definition have to be above that.
- **Perhaps most importantly, one of the Fed's essential jobs is to enact stimulative monetary policy if the economy falls into recession, largely by cutting rates. It can't do that effectively if the rate is already zero or 1%.**

To this list, I would add a few more reasons for not returning to ultra-low interest rates, including the tendency of easy money to (a) induce risk taking and "malinvestment"; (b) encourage increased use of leverage; (c) produce asset bubbles; and (d) create economic winners and losers. **Finally, cutting rates to stimulative territory as soon as inflation hits 2% could cause it to reaccelerate. Instead, the plan should be to get inflation to 2% and then keep rates at a level that is neither stimulative nor restrictive.**

After listing the above bulleted arguments against renewed low rates, I went on in *Sea Change* to say the following (despite my strong aversion to predictions):

> **These are the reasons why I believe that the base interest rate over the next several years is more likely to average 2-4% (i.e., not far from where it is now) than 0-2%.** Of course, there are counterarguments. But, for me, the bottom line is that highly stimulative rates are likely not in the cards for the next several years, barring a serious recession from which we need rescuing . . .

Most people – other than lenders and savers – want low interest rates: people (and businesses) with floating-rate mortgages and other debt, consumers in general, homebuilders, car and boat dealers, private equity firms and their LPs, investors using leverage, and the people charged with paying the interest on our national debt. **But when you consider the reasons for not keeping rates permanently low, as enumerated above, I think the economic merits favor setting rates low only as an emergency measure to rescue the economy from prolonged or severe contractions.**

When I attended graduate school at the University of Chicago, the leading intellectual light was economist Milton Friedman, who argued strenuously that the free market is the best allocator of resources. In this same vein, I'm convinced that so-called "natural" interest rates lead to the best overall allocation of capital. **This is why I so like Chancellor's decision to title his book *The Price of Time*. That's what interest rates are: the price borrowers pay to rent lenders' money for a period of time.** Natural rates reflect supply and demand for money, and they're found at the intersection of (a) the price suppliers of money ask for parting with it temporarily and (b) the price borrowers are willing to pay to use it. Like Chancellor, I think it's clearly best when interest rates are naturally occurring.

> A consensus emerged among [17th-century] English practitioners of "political arithmetick" that interest – defined by one writer as "a Reward for forbearing the use of your own Money for a Term of Time agreed upon" – was much like any other price, whose level should be determined by buyers and sellers in the market, rather than government fiat. (*TPOT*)
>
> Even though it cannot be known with certainty, it is useful to hold in mind how the world would look if the natural rate held sway; . . . a rate that accurately reflects society's time preference; which ensures that we neither borrow too much nor save too little; which ensures capital is used efficiently, and puts an accurate value on land and other assets; a rate which provides savers with a fair return and is not so low as to subsidize bankers and their financial friends, nor so high as to bite borrowers. (*TPOT*)

Or as the central bank head of Germany said in 1927, a time when his counterparts in the U.S. and Great Britain were arguing for easy money, **"Don't give me a low rate, give me a true rate, and then I shall know how to keep my house in order."** (*TPOT*)

Natural rates seem to me to be related to but not quite the same thing as "neutral rates," which are rates that are neither stimulative nor restrictive. Neutral rates are less likely than administered rates to be super-high or super-low, and thus less likely to encourage extreme behavior. As Swedish economist Knut Wicksell said in 1936:

> . . . if the rate of interest was too low, credit would expand rapidly, and inflation would appear. On the other hand, if the rate was kept too high, credit would contract and prices would decline. (*TPOT*)

In my view we haven't had a free market in money since the late 1990s, when I believe the Fed became "activist," eager to head off problems real and imagined by injecting liquidity. Given that activism, investors have become preoccupied with central bank actions and their consequences. For years, that's all investors have talked about.

If I ran the Fed (to be clear, I don't expect to be offered the job), I think I would (a) lower rates to stimulate the economy when it's growing too slowly to produce needed jobs; (b) raise rates to cool off the economy when it's overheating, to head off rising inflation; and (c) keep my hands off rates the rest of time, allowing market forces to determine their level. Under this construct, we certainly wouldn't see rates perpetually near zero, as we did much of the time from 2009 to 2021. (I estimate the fed funds rate averaged roughly 0.5% over that stretch).

Finally, what will we see moving forward? It now appears that sometime in 2024, the Fed will declare victory against inflation and begin to reduce the fed funds rate from today's somewhat restrictive 5.25-5.50%. The current "dot plot," which summarizes the views of Fed officials, shows three 25-bps rate cuts in 2024, bringing the rate to 4.60%, and then more cuts in 2025, taking it to the mid-3s. However, today's consensus thinking among investors seems to be considerably more optimistic than that, anticipating more/earlier/bigger rate cuts.

While on the subject of consensus thinking, I'll point out the following:

- Eighteen months ago, it was near-universally accepted that the Fed's aggressive program of rate increases would result in a recession in 2023. That was wrong.
- Twelve months ago, the optimists who launched the current stock market rally were motivated by their belief that the Fed would pivot to dovishness and start cutting rates in 2023. That was wrong.
- Six months ago, there was a consensus that there would be one more rate increase in late 2023. That was wrong.

I find it interesting that the current stock market rally began as a result of optimism powered by consensus thinking that was generally off target. (See the second bullet point just above.)

At present, I believe the consensus is as follows:

- Inflation is moving in the right direction and will soon reach the Fed's target of roughly 2%.
- As a consequence, additional rate increases won't be necessary.
- As a further consequence, we'll have a soft landing marked by a minor recession or none at all.
- Thus, the Fed will be able to take rates back down.
- This will be good for the economy and the stock market.

Before going further, I want to note that, to me, these five bullet points smack of "Goldilocks thinking": the economy won't be hot enough to raise inflation or cold enough to bring on an economic slowdown. I've seen Goldilocks thinking in play a few times over the course of my career, and it rarely holds for long. Something usually fails to operate as hoped, and the economy moves away from perfection. **One important effect of Goldilocks thinking is that it creates high expectations among investors and thus room for potential disappointment (and losses).** *FT Unhedged* recently expressed a similar view:

> Yesterday's letter suggested that we think the market's current expectation of solid growth and six rate cuts seemed likely to be wrong in one direction or the other: either strong growth will limit the Fed to close to the three rate cuts it currently forecasts, or growth will be weak and there will be as many cuts as the market expects. In this sense, the market does look to be pricing in too much good news. (December 20, 2023)

I don't have an opinion as to whether the consensus described above is correct. However, even granting that it is, I'll still stick with my guess that rates will be around 2-4%, not 0-2%, over the next few years. Do you want more specificity? My guess – and that's all it is – is that the fed funds rate will average between 3.0% and 3.5% over the next 5-10 years. If you think I'm wrong, ask yourself whether you'd put your money on a different half-point range. (Before readers protest my uncharacteristic descent into forecasting, I'll point out that, at Oaktree, we say it's okay to have opinions on the macro; it's just not okay to bet clients' money on them. We invest with an awareness of current macro conditions, but our investment decisions are always based on bottom-up analysis of companies and securities, not macro forecasts.)

* * *

The upshot of my sea change thesis is simple:

1. The period from 1980 through 2021 was generally one of declining and/or ultra-low interest rates.
2. This had profound ramifications in many areas, including determining which investment strategies would be the winners and losers.
3. That changed in 2022, when the Fed was forced to begin raising interest rates to combat inflation.
4. We're unlikely to go back to such easy money conditions, other than temporarily in response to recessions.
5. **Therefore, the investment environment in the coming years will feature higher interest rates than those we saw in 2009-21. Different strategies will outperform in the period ahead, and thus a different asset allocation is called for.**

Bullet points one through three above are statements of fact and not controvertible. Consequently, the conclusion – number five – depends exclusively on whether number four is correct. The question is simple: do you agree with it or don't you? If you agree, we have a host of solutions to propose.

January 9, 2024

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Indispensability of Risk

Oftentimes, we're best able to understand something we're interested in through analogies that clarify the matter by establishing connections between it and other parts of life. That's why I've written a memo comparing investing to sports in each of the four decades I've been writing memos and one connecting investing and card playing in 2020.

The motivation for this memo comes from an article in *The Wall Street Journal* of April 12 that my partner Bruce Karsh sent me entitled "Chess Teaches the Power of Sacrifice" by Maurice Ashley, a chess grandmaster who has been inducted into the U.S. Chess Hall of Fame. Few people know that Bruce is a chess player, and I hadn't thought about this fact for years, but the article provided a good reminder and moved me to dash off this memo.

As is obvious from the article's title, the piece is mostly about the role of sacrifice. Ashley says, "Many positions cannot be won or saved without something of value being given away, from a lowly pawn all the way up to the mighty queen." Intentionally losing a piece as part of one's gameplan is the sacrifice that Ashley is referencing.

- He describes some sacrifices as "shams," (a term coined by chess master Rudolf Spielmann in his book *The Art of Sacrifice in Chess*) where ". . . one can easily see that the piece being given up will return concrete benefits that can be clearly calculated." In other words, I put a piece in clear jeopardy, but I do this so that I'll be able to take one of yours of greater value.
- Others are deemed "real" sacrifices, where ". . . giving away a piece offers gains that are neither immediate nor tangible. The return on investment might be controlling more space, creating an assailable weakness in the opponent's position, or having more pieces in the critical sector of attack."

The analogy to investing begins to become clear. Buying a 10-year U.S. Treasury note is a modest or "sham" sacrifice. You give up the use of your money for ten years, but that's only an opportunity cost, and accepting it brings the certainty of interest income. Most other investments involve real sacrifices, though, where the risk of loss is borne in pursuit of "gains that are neither immediate nor tangible."

Ashley goes on to speak of sacrifice in risk/return terms that are familiar to investors. He describes his mother's decision to leave him (at age two) and his two siblings in Jamaica and travel to the U.S. in search of a better life for herself and for them. She reached her goal a decade later and was able to bring her kids to the U.S., where they would find success in a variety of fields:

> **It did not have to turn out that way.** It did because she was willing to stomach the key aspect of making real sacrifices: **the willingness to take risks.** For a chess player, risk is as much intuited as it is calculated. Due to the inherent complexity of the game, it is virtually impossible to assess with certainty whether a risky move will pay off in the end. **It's up to the player to decide if sufficient conditions have been met to take the chance on a risky move. . . .**

> What we do know, however, is that the famous saying "No risk, no reward" is true in many cases. A skilled adversary is normally able to handle solid, conservative play and therefore able to rob us of opportunities that may be inherent in our position. As [five-time world chess champion] Magnus Carlsen put it, "Not being willing to take risks is an extremely risky strategy." (Emphasis added)

And there you have it: the indispensability of risk.

The Risk of Not Taking Risk

Because the future is inherently uncertain, we usually have to choose between (a) avoiding risk and having little or no return, (b) taking a modest risk and settling for a commensurately modest return, or (c) taking on a high degree of uncertainty in pursuit of substantial gain but accepting the possibility of substantial permanent loss. Everyone would love a shot at earning big gains with little risk, but the "efficiency" of the market – meaning the fact that the other participants in the market aren't dummies – usually precludes this possibility.

Most investors are capable of accomplishing "a" and most of "b." The challenge in investing lies in the pursuit of some version of "c." **Earning high returns – in absolute terms or relative to other investors in a market – requires that you bear meaningful risk – either the possibility of loss in the pursuit of absolute gain or the possibility of underperformance in the pursuit of outperformance. In each case, the two are inseparable.** As Ashley says, no risk, no reward. No pain, no gain.

The risk inherent in not taking enough risk is very real. Individual investors who eschew risk may end up with a return that is insufficient to support their cost of living. And professional investors who take too little risk may fail to keep up with their clients' expectations or their benchmarks.

Like chess (and most card games), backgammon requires the calculation of when to take risk and when to avoid it. In backgammon, two players move their checkers around the board based on throws of a pair of dice. One player moves clockwise and the other counterclockwise. When players' checkers come near each other, the player who's moving often has a choice between (a) landing on one of the other player's checkers, sending it back to the start (but at the risk of leaving the moving checker in a vulnerable position), and (b) avoiding doing so to play it safe. No one wants to be exposed and get hit. But most beginners play it too safe, and because they put so much emphasis on avoiding getting hit, they rarely win.

Relevant lessons from sports (included in past memos) are easily accessed and also very helpful:

- "You miss 100% of the shots you don't take." – Wayne Gretzky, NHL Hall of Famer
- "You have to give yourself a chance to fail." – Kenny "The Jet" Smith, two-time NBA champion

I'll sum up with a paragraph from my memo of last September, *Fewer Losers, or More Winners?* The final sentence says a great deal about sacrifice and risk:

> . . . not having any losers isn't a useful goal. The only sure way to achieve that is by not taking any risk. But … risk avoidance is likely to result in return avoidance. There's such a thing as the risk of taking too little risk. Most people understand this intellectually, but **human nature makes it hard for many to accept the idea that the willingness to live with some losses is an essential ingredient in investment success.**

How to Think About Risk-Taking

The paradox of risk-taking is inescapable. You have to take it to be successful in competitive, high-aspiration arenas. But taking it doesn't mean you'll be successful; that's why they call it risk.

Equally paradoxical, earning a high rate of return over a long time period doesn't have to – and usually doesn't – connote a record of consistent success. More often it results from having made a lot of well-reasoned investments, some subset of which worked out well. Here's how I described the basis for the success of Berkshire Hathaway in *Fewer Losers, or More Winners?*:

> I believe the ingredients of Warren [Buffett]'s and Charlie [Munger]'s great performance are simple: (a) a lot of investments in which they did decently, (b) a relatively small number of big winners that they invested in heavily and held for decades, and (c) relatively few big losers. No one should expect to have – or expect their money managers to have – all big winners and no losers.

Investors must accept that success is likely to stem from making a large number of investments, all of which you make because you expect them to succeed, but some portion of which you know won't. You have to put it all out there. You have to take a shot. Not every effort will be rewarded with high returns, but hopefully enough will do so to produce success over the long term. That success will ultimately be a function of the ratio of winners to losers, and of the magnitude of the losses relative to the gains. But refusal to take risk in this process is unlikely to get you where you want to go.

I'll conclude with another good paragraph from Ashley:

> Taking a chance doesn't mean there will be a successful outcome, nor does it require it. If the reasons are sound, the risk should be taken almost reflexively. The more often we trust our judgment, the more confidence we gain in our decision-making capacity. The courage to take risks becomes a worthwhile end in itself.

The bottom line on the quest for superior investment returns is clear: **You shouldn't expect to make money without bearing risk, but you shouldn't expect to make money just for taking risk. You have to sacrifice certainty, but it has to be done skillfully and intelligently, and with emotion under control.**

April 17, 2024

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Impact of Debt

My partner Bruce Karsh recently supplied me with a newspaper article about chess that inspired me to write a brief memo called *The Indispensability of Risk*. The response to the memo was favorable, hopefully because people found the content valuable, but quite possibly because it was only three pages long versus the usual ten to twelve. Thus encouraged, I'm following up with another short memo.

One of my more interesting sources for readings on practical philosophy – including investment philosophy – is the blog from the Collaborative Fund to which Morgan Housel, a fund partner, is a regular contributor. As I read Housel's musings, I often find myself saying, "that's right in line with what I think." And at other times, I say, as I hope others say after reading my memos, "I never thought of it that way."

I found Housel's April 30 article, entitled "How I Think About Debt," particularly interesting. The subject is the impact of debt on longevity, and it really boils down to a discussion of risk, one of my favorite topics.

Housel starts by discussing the 140 businesses in Japan that are still operating more than 500 years after they were founded and the few that are purportedly more than 1,000 years old.

> It's astounding to think what these businesses have endured – dozens of wars, emperors, catastrophic earthquakes, tsunamis, depressions, on and on, endlessly. And yet they keep selling, generation after generation.
>
> These ultra-durable businesses are called "shinise," and studies of them show they tend to share a common characteristic: they hold tons of cash, and no debt. That's part of how they endure centuries of constant calamities.

Clearly, all else being equal, people and companies that are indebted are more likely to run into trouble than those that aren't. And it goes without saying that a home or car that hasn't been used as collateral for a loan can't be foreclosed on or repossessed. It's the presence of debt that creates the possibility of default, foreclosure, and bankruptcy.

Does that mean debt is a bad thing and should be avoided? Absolutely not. Rather, it's a matter of whether the amount of debt is appropriate relative to (a) the size of the overall enterprise and (b) the potential for fluctuations in the enterprise's profitability and asset value.

Housel frames the issue by introducing the idea of potential volatility over one's lifetime: "Not just market volatility, but . . . world and life volatility: recessions, wars, divorces, illness, moves, floods, changes of heart, etc." With no debt, he postulates, we're likely to survive all but the most infrequent, most volatile events. But in a succession of illustrations, Housel shows that as the level of one's indebtedness increases, the range of volatility one can withstand narrows, until at a very high level of debt, only the tamest of environments are survivable. As Housel puts it, "**as debt increases, you narrow the range of outcomes you can endure in life.**"

Housel's approach to thinking about debt – and especially his illustrations – reminded me of my December 2008 memo, *Volatility + Leverage = Dynamite*. (Unless otherwise indicated, this memo is the source of the quotations that follow; in all cases, emphasis is in the original.) In that memo, I used a series of simple graphics to show that the lower a company's debt load is, the greater the decline in fortune it could survive. And I made the following observation about the root cause of the Global Financial Crisis, which was in full force at the time of the memo:

> **. . . the amount of borrowed money – leverage – that it's prudent to use is purely a function of the riskiness and volatility of the assets it's used to purchase.** The more stable the assets, the more leverage it's safe to use. Riskier assets, less leverage. It's that simple.
>
> **One of the main reasons for the problem today at financial institutions is that they underestimated the risk inherent in assets such as home mortgages and, as a result, bought too much mortgage-backed paper with too much borrowed money.**

Portfolios, Leverage, and Volatility

The reason for taking on debt – i.e., using what investors call "leverage" – is simple: to increase so-called capital efficiency. Debt capital is usually cheap relative to the expected returns that motivate equity investments and thus relative to the imputed cost of equity capital. Thus, it's efficient to use it in lieu of equity. **In casinos, I've heard the pit boss say, "The more you bet, the more you win when you win." Likewise, for a given amount of equity capital, (a) the more debt capital you use, the more assets you can own and (b) the more assets you own, the greater your profits will be . . . when things go well.**

But few people talk about the downside. The pit boss never says, ". . . and the more you lose when you lose." Likewise, when your assets decline in value, the more leverage you've employed, the more equity loss you'll suffer.

The magnification of gains and losses stemming from leverage is typically symmetrical: a given amount of leverage amplifies gains and losses similarly. But levered portfolios face a downside risk to which there isn't a corresponding upside: the risk of ruin. **The most important adage regarding leverage reminds us to "never forget the six-foot-tall person who drowned crossing the stream that was five feet deep on average."** To survive, you have to get through the low points, and the more leverage you carry (everything else being equal), the less likely you are to do so.

> . . . it's important to recognize the role of volatility. Even if losses aren't permanent, a downward fluctuation can bring risk of ruin if a portfolio is highly leveraged and (a) the lenders can cut off credit, (b) investors can be frightened into withdrawing their equity, or (c) the violation of regulatory or contractual standards can trigger forced selling.

Obviously, the greatest leverage-related losses occur when the potential for downward fluctuations has been underestimated for a meaningful period of time and thus the use of leverage has become excessive. Generally speaking, "normal levels of volatility" – those seen on a regular basis and documented through historical statistics – are used in investors' calculations and reflected in the amounts of leverage they employ. It's the isolated "tail events" that saddle levered investors with the greatest losses:

The problem is that extreme volatility and loss surface only infrequently. And as time passes without that happening, it appears more and more likely that it'll never happen – that assumptions regarding risk were too conservative. Thus, it becomes tempting to relax rules and increase leverage. And often this is done just before the risk finally rears its head. As Nassim Nicholas Taleb wrote in *Fooled by Randomness*:

> Reality is far more vicious than Russian roulette. First, it delivers the fatal bullet rather infrequently, like a revolver that would have hundreds, even thousands of chambers instead of six. After a few dozen tries, one forgets about the existence of a bullet, under a numbing false sense of security . . . Second, unlike a well-defined precise game like Russian roulette, where the risks are visible to anyone capable of multiplying and dividing by six, one does not observe the barrel of reality. . . . One is thus capable of unwittingly playing Russian roulette – and calling it by some alternative "low risk" name.

. . . **In all aspects of our lives, we base our decisions on what we think probably will happen. And, in turn, we base that to a great extent on what usually happened in the past.** We expect results to be close to the norm most of the time, but we know it's not unusual to see outcomes that are better or worse. Although we should bear in mind that, once in a while, a result will be outside the usual range, we tend to forget about the potential for outliers. And importantly, as illustrated by recent events, we rarely consider outcomes that have happened only once a century . . . or never.

<ins>Cycles in the Use of Leverage</ins>

In my second book, *Mastering the Market Cycle: Getting the Odds on Your Side*, one of the longest chapters, and probably the most important, is one I hadn't planned when I first sat down to write: "The Cycle in Attitudes Toward Risk." Investor psychology has a dominant influence on the market in the short run, and the attitudes that motivate investment decisions are often cyclical in nature, driving markets to irrational extremes and then correcting in the opposite direction . . . to the opposite extreme.

Attitudes that govern the use of debt capital are examples of this cyclical process. When things have been going well for a while – asset prices have been rising, investment returns have been positive, and the use of leverage has paid off in the form of higher returns – investors view leverage as benign. As a result:

- the favorable aspects of leverage become well-recognized,
- the negative potential is overlooked,
- investors become interested in employing more,
- lenders become willing to provide more, and
- regulations and mores governing the use of leverage tend to become more permissive.

But when events turn negative, this process goes into reverse. Leverage is penalized, not rewarded. Thus, its use declines. And importantly, lenders provide less and try to demand repayment of outstanding leverage if they can, leading to negative consequences for borrowers. In this way, as we so frequently see, psychology often strays from the "happy medium" and moves toward extreme highs that presage painful losses when extreme lows are reached.

The source of losses from excessive use of leverage might be best understood through an adaptation of my favorite new quote, from Edward Chancellor's book *The Price of Time*, which I cited in this past

January's memo *Easy Money*:

> The Manchester Banker John Mills commented perceptively [in 1865] that "as a rule, panics do not destroy capital; they merely reveal the extent to which it has previously been destroyed by [the taking on of excessive leverage in good times]."

Using Debt Prudently

As with so many aspects of investing, determining the proper amount of leverage has to be a function of *optimizing, not maximizing*. Given that leverage magnifies gains when there are gains and that investors only invest when they expect there to be gains, it can be tempting to think the right amount of leverage is "all you can get." But if you bear in mind (a) leverage's potential to magnify losses when there are losses and (b) the risk of ruin under extreme negative circumstances, investors should usually use less than the maximum available. Successful investments, perhaps enhanced by the moderate use of leverage, should usually provide a good-enough return – something few people think about in good times.

Here's how I summed it up in *Volatility + Leverage = Dynamite*:

> Clearly, it's difficult to always use the right amount of leverage, because it's difficult to be sure you're allowing sufficiently for risk. Leverage should only be used on the basis of demonstrably cautious assumptions. And it should be noted that **if you're doing something novel, unproven, risky, volatile, or potentially life-threatening, you shouldn't seek to maximize returns. Instead, err on the side of caution. The key to survival lies in what Warren Buffett constantly harps on: margin of safety.** Using 100% of the leverage one's assets might justify is often incompatible with assuring survival when adverse outcomes materialize. . . .
>
> **The riskier the underlying assets, the less leverage should be used to buy them.** Conservative assumptions on this subject will keep you from maximizing gains but possibly save your financial life in bad times.

The right way to think about debt may be best captured by one of the oldest maxims: "There are old investors, and there are bold investors, but there aren't many old bold investors." Using a moderate amount of borrowed capital balances the desire for enhanced gains against the awareness of the potential negative consequences. It's only in this way that one can hope to attain the longevity of Morgan Housel's 500-year-old success stories.

May 8, 2024

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Folly of Certainty

The impetus for my memos can come from a wide variety of sources. This one was inspired by an article in *The New York Times* on Tuesday, July 9. What caught my eye were a few words in the sub-headline: **"She doesn't have any doubt."** The speaker was Ron Klain, a former Biden chief of staff. The subject was whether President Biden should continue to run for reelection. And the "she" was Jen O'Malley Dillon, Biden's campaign chair. The article went on to quote her as having said, "Joe Biden is going to win, period," in the days just before his June 27 debate against former President Donald Trump.

And, with that, I had the subject of this memo: not whether Biden will continue campaigning or drop out – or whether he'll win if he continues – but rather how anyone can be without doubt. It'll be another of my "shortie" memos given the uncertain shelf life of the Biden candidacy.

This choice of subject calls to mind another time I heard a highly credentialed person express absolute certainty. In that case, an acknowledged expert in foreign affairs told a group I was part of there was "a 100% probability that the Israelis would 'take out' Iran's nuclear capability before year-end." He seemed like a genuine insider, and I had no reason to doubt his word. Yet, that was 2015 or '16, and I'm still waiting for "before year-end" to come around (in his defense, he didn't say which year).

As I indicated in my memo *The Illusion of Knowledge* (September 2022), there's no way a macro-forecaster can produce a forecast that correctly incorporates all the many variables that we know will affect the future as well as the random influences about which little or nothing can be known. It's for this reason, as I've written in the past, that investors and others who are subject to the vagaries of the macro-future should avoid using terms such as "will," "won't," "has to," "can't," "always," and "never."

Politics

When the 2016 presidential election rolled around, there were two things about which almost everyone was certain: (a) Hillary Clinton would win but (b) if by some quirk of fate Donald Trump were to win, the stock market would collapse. The least certain pundits said Clinton was 80% likely to win, and the estimates of her probability of victory ranged upward from there.

And yet, Trump won, and the stock market rose more than 30% over the next 14 months. The response of most forecasters was to tweak their models and promise to do better next time. Mine was to say, "if that's not enough to convince you that (a) we don't know what's going to happen and (b) we don't know how the markets will react to what actually does happen, I don't know what is."

Even before the much-discussed presidential debate of three weeks ago, no one I know expressed much confidence regarding the outcome of the coming election. Today, Ms. O'Malley Dillon would likely soften her position regarding the certainty of a Biden victory, explaining that she was blindsided by the debate result. But that's the point! We don't know what's going to happen. Randomness exists.

Sometimes things go as people expected, and they conclude that they knew what was going to happen. And sometimes events diverge from people's expectations, and they say they would have

been right if only some unexpected event hadn't transpired. But, in either case, the chance for the unexpected – and thus for forecasting error – was present. In the latter instance, the unexpected materialized, and in the former, it didn't. But that doesn't say anything about the likelihood of the unexpected taking place.

Macro Economics

In 2021, the U.S. Federal Reserve held the view that the bout of inflation then underway would prove "transitory," which it has subsequently defined as meaning temporary, not entrenched, and likely to self-correct. I think the Fed might have been proved right, given enough time. Inflation might have retreated of its own accord in three or four years, after (a) the Covid-19 relief funds that caused the surge in consumer spending were spent down and (b) the global supply chain returned to its normal operations. (However, not slowing the economy would have brought the risk that inflationary psychology might take hold in those 3-4 years, necessitating even stronger action.) But because the Fed's view wasn't borne out in 2021 and waiting longer was untenable, the Fed was forced to embark on one of the fastest programs of interest rate increases in history, with profound implications.

In mid-2022, there was near certainty that the Fed's rate increases would precipitate a recession. It made sense that the dramatic increase in interest rates would shock the economy. Further, history clearly showed that major central bank tightening has almost always led to economic contraction rather than a "soft landing." And yet, no recession has materialized.

Instead, late in 2022, the consensus among market observers shifted to the view that (a) inflation was easing, and this would permit the Fed to start cutting interest rates, and (b) rate cuts would enable the economy to avoid recession or ensure that any contraction would be mild and short-lived. This optimism ignited a stock market rally in late 2022 that persists today.

And yet, the anticipated rate reductions in 2023 that undergirded the rally didn't transpire. Then, in December 2023, when the "dot plot" of Fed officials' views called for three interest rate cuts in 2024, the optimists driving the market doubled down, pricing in an expectation of six. Inflation's stubbornness has precluded any rate cuts thus far, with 2024 more than half over. Now the consensus has coalesced around the idea of a first cut in September. And the stock market keeps hitting new highs.

The optimists today would likely say, "We were right. Look at those gains!" But, regarding interest rate cuts, they were simply wrong. For me, all this does is serve as another reminder that we don't know what's going to happen or how markets will react to what does happen.

Conrad DeQuadros of Brean Capital, my favorite economist (how's that for an oxymoron?), has supplied an interesting tidbit for this memo on the subject of economists' conclusions:

> I use the Philly Fed's Anxious Index (the probability of a decline in real GDP in the upcoming quarter) as an indicator that a recession has ended. **By the time more than 50% of the economists in the survey project a decline in real GDP in the coming quarter, the recession is over or close to being over.** (Emphasis added)

In other words, the only thing worthy of certainty is the conclusion that economists shouldn't be expressing any of it.

Markets

The rare person who in October 2022 correctly predicted that the Fed wouldn't cut interest rates over the next 20 months was absolutely right . . . and if that prediction kept them out of the market, they've missed out on a gain of roughly 50% in the Standard & Poor's 500 index. The rate-cut optimist, on the other hand, was absolutely wrong about rates but is likely much richer today. So, yes, market behavior is very tough to gauge correctly. But I'm not going to take time here to catalog the errors of market savants.

Instead, I'd like to focus on *why* so many market forecasts fail. The performance of economies and companies might tend toward predictability given that the forces governing them are somewhat . . . shall I say . . . mechanical. In these areas, one might say "if A, then B" with some degree of confidence. Predictions here might, therefore, have some chance of being correct, albeit that's mostly the case when trends continue unabated and extrapolation works.

But markets swing more than economies and companies. Why? Because of the importance and unpredictability of market participants' psyches or emotions. Thanks to further help from Conrad DeQuadros, I can illustrate the greater variability of markets, as follows:

40-Year Standard Deviation of Annual Percentage Changes

GDP	1.8%
Corporate profits	9.4
S&P 500 price	13.1

Why is it that stock prices rise and fall so much more than the economies and companies that underlie them? And why is it that market behavior is so hard to predict and often seems unconnected to economic events and company fundamentals? **The financial "sciences" – economics and finance – assume that each market participant is a homo economicus: someone who makes rational decisions designed to maximize their financial self-interest. But the crucial role played by psychology and emotion often causes this assumption to be mistaken.** Investor sentiment swings a great deal, swamping the short-run influence of fundamentals. It's for this reason that relatively few market forecasts prove correct, and fewer still are "right for the right reason."

* * *

Today, pundits are making all sorts of predictions about the upcoming presidential election. Many of their conclusions seem well-reasoned and even persuasive. We hear and read statements from those who believe Biden should and shouldn't drop out; those who think he will and won't; those who think he can win if he stays in the race; and those who think he's sure to lose. **Obviously, intelligence, education, access to data, and powers of analysis can't be sufficient to produce correct forecasts. Many of these commentators possess these attributes, but clearly, they won't all be right.**

Over the years, I've often cited the wisdom of John Kenneth Galbraith. It's he who said, "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." I find myself using this quote all the time. Another of my favorite Galbraith quotes is from his book *A Short History of Financial Euphoria*. In describing the reasons for "speculative euphoria and programmed collapse," he discusses two factors "little noted in our time or in past times. One is the extreme brevity of the financial memory." I often cite this factor, too.

But I don't remember ever writing about his second factor, which Galbraith says is "the specious association of money and intelligence." When people get rich, others take that to mean they're smart. And when investors succeed, it's often assumed their intelligence can lead to similarly good results in other fields. Further, successful investors often come to believe in the strength of their own intellect and opine about fields with no connection to investing.

But investors' success can be the result of a string of lucky breaks or a propitious environment, rather than any special talents. They may or may not be intelligent, but often they don't know any more than most others about subjects outside of investing. Nevertheless, many are unsparing with their opinions, and those opinions often are highly valued by the general populace. That's the specious part. And today we find some of them speaking with conviction on all sides of the issues related to the election.

A lot has been said about those who express certainty. We all know people we'd describe as "often wrong but never in doubt." This reminds me of another of my favorite quotes, one that's attributed (perhaps tenuously) to Mark Twain: "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."

Back in mid-2020, when the pandemic seemed to have become a more or less understood phenomenon, I slowed the pace of my memo writing from the one-a-week pattern of March and April. In May, I took the opportunity for two non-Covid-related memos titled *Uncertainty* and *Uncertainty II*, in which I devoted a significant amount of space to the subject of intellectual humility. While these memos were on one of my favorite topics, they generated little response. So, I'll quote a bit from *Uncertainty* and hopefully give you reason to look back at them.

> Here's part of the article that first brought the subject of intellectual humility to my attention:
>
> > As defined by the authors, intellectual humility is the opposite of intellectual arrogance or conceit. In common parlance, it resembles open-mindedness. Intellectually humble people can have strong beliefs, but recognize their fallibility and are willing to be proven wrong on matters large and small. (Alison Jones, *Duke Today*, March 17, 2017)
>
> **. . . To put it simply, intellectual humility means saying "I'm not sure," "The other person could be right," or even "I might be wrong." I think it's an essential trait for investors; I know it is in the people I like to associate with. . . .**
>
> No statement that starts with "I don't know but . . ." or "I could be wrong but . . ." ever got anyone into big trouble. If we admit to uncertainty, we'll investigate before we invest, double-check our conclusions and proceed with caution. We may sub-optimize when times are good, but we're unlikely to flame out or melt down. **On the other hand, people who are sure may dispense with those things, and if they're sure and wrong, as the Twain quote suggests, the outcome can be catastrophic. . . .**
>
> . . . maybe Voltaire said it best 250 years ago: **Doubt is not a pleasant condition, but certainty is absurd.**

There simply is no place for certainty in fields that are influenced by psychological fluctuations, irrationality, and randomness. Politics and economics are two such fields, and investing is another. No one can predict reliably what the future holds in these fields, but many people overrate their ability and attempt to do so nevertheless. **Eschewing certainty can keep you out of trouble. I strongly recommend doing so.**

P.S.: Last summer's Grand Slam tennis tournaments provided the inspiration for my memo *Fewer Losers, or More Winners?* Similarly, this past Saturday's women's final match at Wimbledon has provided a snippet for this memo. Barbora Krejcikova prevailed over Jasmine Paolini to win the women's title. Before the tournament, bettors considered Krejcikova a 125-to-1 shot. In other words, they were sure she wouldn't win. The bettors may have been right to doubt her potential, but it seems they shouldn't have been quite so certain in making their predictions.

And speaking of the unpredictable, I can't fail to mention the recent attempt on Donald Trump's life, an event that could well have had a more grave and impactful result. Even now that it has happened and President Trump has escaped serious injury, no one can state with certainty how it will impact the election (though at present it appears to bolster Trump's prospects) or the markets. So, if anything, it reinforces my bottom line: making predictions is largely a loser's game.

July 17, 2024

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Memo to:	Oaktree Clients
From:	Howard Marks
Re:	Mr. Market Miscalculates

In his book *The Intelligent Investor*, first published in 1949, Benjamin Graham, who was Warren Buffett's teacher at Columbia Business School, introduced a fellow he called Mr. Market:

> Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.

Of course, Graham intended Mr. Market as a metaphor for the market as a whole. Given Mr. Market's inconsistent behavior, the prices he assigns to stocks each day can diverge – sometimes wildly – from their fair value. When he's overenthusiastic, you can sell to him at prices that are intrinsically too high. And when he's overly fearful, you can buy from him at prices that are fundamentally too low. **Thus, his miscalculations provide profit opportunities to investors interested in taking advantage of them.**

*   *   *

There's a great deal to be said about investors' foibles, and I've shared much of it over the years. But the rapid market decline we saw in the first week of August – along with the rapid rebound – compels me to pull together what I've said previously on the subject, along with some priceless investing cartoons from my collection, and add a few new observations.

To set the scene, let's review recent events. As a result of the Covid-19 pandemic, soaring inflation, and the U.S. Federal Reserve's rapid interest rate increases, 2022 was one of the worst years ever for the combination of stocks and bonds. Sentiment reached its low around the middle of 2022, with investors depressed by the universally negative outlook: "We have inflation, and that's bad. And the rate increases to fight it are sure to bring on a recession, and that's bad." Investors could think of few positives.

Then the mood lightened and, late in 2022, investors coalesced around a positive narrative: the slow economic growth would cause inflation to decline, and that would permit the Fed to start lowering rates in 2023, leading to economic vigor and market gains. A significant stock market rally began and continued nearly uninterrupted until this month. Although the rate cuts anticipated in 2022 and 2023 still haven't materialized, optimism has been in the ascendency in the stock market. The S&P 500 stock index rose by 54% (not counting dividends) in the 21 months which ended on July 31, 2024. That day, Fed Chair Jerome Powell confirmed that the Fed was moving closer to a rate cut, and things appeared to be on track for economic growth and further stock market appreciation.

But that same day, the Bank of Japan announced its biggest increase in its short-term interest rate in over 17 years (to a whopping 0.25%!). This shocked the Japanese stock market, to which people had been warming for over a year. In addition, and importantly, the announcement played havoc with investors who had engaged in "the carry trade." For years, Japan's infinitesimal – and often negative – interest rates have meant that people could borrow cheaply in Japan and invest the borrowed funds in any number of assets, there and elsewhere, that promised to return more, for a "positive carry" (aka "free money"). This led to the establishment of highly levered positions. It seems odd that a quarter-point increase in interest rates could require some of these positions to be unwound. But it did, leading to motivated selling in a variety of asset classes as those who had engaged in the practice moved to cut their leverage.

Starting the next day, the U.S. announced mixed economic news. On August 1, we learned that the Manufacturing Purchasing Managers' Index had dipped and initial jobless claims had risen. On the other hand, corporate profit margins continued to look good, and gains in productivity surprised to the upside. A day later, we learned that employment gains had moderated, with hiring rising less than had been expected. The unemployment rate stood at 4.3% at the end of July, up from a low of 3.4% in April 2023. This was still very low by historical standards, but, according to the suddenly popular "Sahm Rule" (don't complain to me; I'd never heard of it either), since 1970, an increase in the three-month average unemployment rate of 0.5 percentage points or more from the low of the prior 12 months has never occurred without the economy already being in recession. Around the same time, Warren Buffett's Berkshire Hathaway announced that it had sold off a good part of its massive holding of Apple shares.

In all, this news constituted a triple whammy. The resulting flip-flop from optimism to pessimism set off a significant stock market rout. The S&P 500 fell on three consecutive trading days – August 1, 2, and 5 – by a total of 6.1%. The replay of the mistakes I've witnessed for decades was so obvious that I can't resist cataloging them below.

What's Behind the Market's Volatility?

On the first two days of August, I was in Brazil, where people often asked me to explain the sudden collapse. I referred them to my 2016 memo *On the Couch*. **Its key observation was that in the real world, things fluctuate between 'pretty good' and 'not so hot,' but in investing, perception often swings from 'flawless' to 'hopeless.'** That says about 80% of what you need to know on the subject.

If reality changes so little, why do estimates of value (that's what security prices are supposed to be) change so much? The answer has a lot to do with changes in mood. I wrote over 33 years ago, in only my second memo:

> The mood swings of the securities markets resemble the movement of a pendulum. . . . between euphoria and depression, between celebrating positive developments and obsessing over negatives, and thus between overpriced and underpriced. This oscillation is one of the most dependable features of the investment world, and investor psychology seems to spend much more time at the extremes than it does at a "happy medium." (*First Quarter Performance*, April 1991)

Mood swings do a lot to alter investors' perception of events, causing prices to fluctuate madly. When prices collapse as they did at the start of this month, it's not because conditions have suddenly *become* bad. Rather, they become *perceived* as bad. Several factors contribute to this process:

- heightened awareness of things on one side of the emotional ledger,
- a tendency to overlook things on the other side, and
- similarly, a tendency to interpret things in a way that fits the prevailing narrative.

What this means is that in good times, investors obsess about the positives, ignore the negatives, and interpret things favorably. Then, when the pendulum swings, they do the opposite, with dramatic effects.

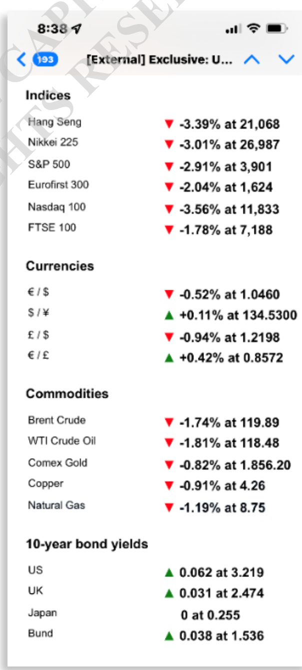
One important idea underpinning economics is the theory of rational expectations, described by *Investopedia* as follows:

> The rational expectations theory . . . posits that individuals base their decisions on three primary factors: their human rationality, the information available to them, and their past experiences.

If security prices were really the result of the rational, dispassionate evaluation of data, presumably one piece of negative information would move the market down a little, and the next such piece would move it down a bit more, and so forth. But instead, we see that an optimistic market is capable of ignoring individual pieces of bad news until a critical mass of bad news builds up, at which time a tipping point is reached, the optimists surrender, and a rout begins. Rudiger Dornbush's great quote about economics is highly applicable here: ". . . things take longer to happen than you think they will, and then they happen faster than you thought they could." Or as my partner Sheldon Stone says, "The air goes out of the balloon much faster than it went in."

The non-linear nature of this process suggests something very different from rationality is at work. In particular, as in many other aspects of life, cognitive dissonance plays a big part in investors' psyches. **The human brain is wired to ignore or reject incoming data that is at odds with prior beliefs, and investors are particularly good at this.**

While we're on the subject of irrationality, I've been waiting for an opportunity to share the following screenshot from June 13, 2022: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193 [External] Exclusive: U...

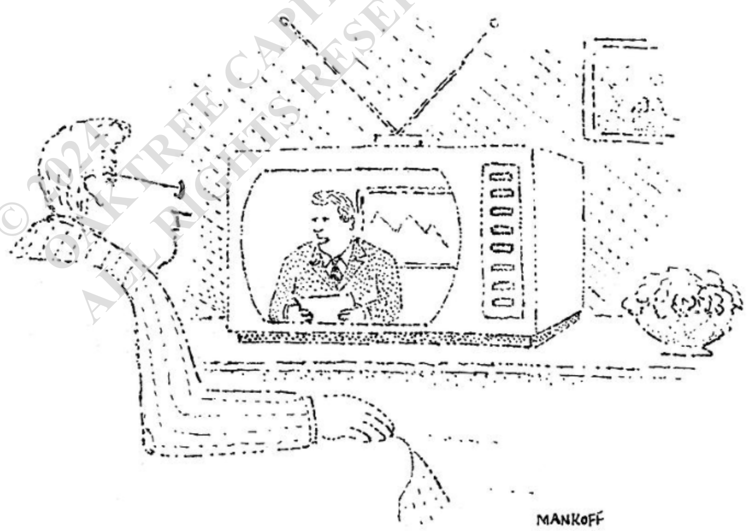
Indices	
Hang Seng	▼ -3.39% at 21,068
Nikkei 225	▼ -3.01% at 26,987
S&P 500	▼ -2.91% at 3,901
Eurofirst 300	▼ -2.04% at 1,624
Nasdaq 100	▼ -3.56% at 11,833
FTSE 100	▼ -1.78% at 7,188
Currencies	
€ / $	▼ -0.52% at 1.0460
$ / ¥	▲ +0.11% at 134.5300
£ / $	▼ -0.94% at 1.2198
€ / £	▲ +0.42% at 0.8572
Commodities	
Brent Crude	▼ -1.74% at 119.89
WTI Crude Oil	▼ -1.81% at 118.48
Comex Gold	▼ -0.82% at 1.856.20
Copper	▼ -0.91% at 4.26
Natural Gas	▼ -1.19% at 8.75
10-year bond yields	
US	▲ 0.062 at 3.219
UK	▲ 0.031 at 2.474
Japan	0 at 0.255
Bund	▲ 0.038 at 1.536

This was a tough day in the markets: interest rates were rising thanks to the actions of the Fed and other central banks, and asset prices were under significant pressure as a result. But take a look at the table. Every country's equity index was down significantly. Every currency was down relative to the dollar. Every commodity was down. Only one thing was up: bond yields . . . meaning bond prices were down, too. Wasn't there one asset or country whose value didn't decline that day? What about gold, which is supposed to do well in difficult times? My point here is that, during big market moves, no one performs rational analysis or makes distinctions. They just throw out the baby with the bathwater, primarily because of psychological swings. As the old saying goes, **"in times of crisis, all correlations go to 1."**

Further, the data in the table exhibit an additional phenomenon that's often present during extreme moves: contagion. Something goes wrong in the U.S. market. European investors take that as a sign of trouble, so they sell. Asian investors detect that something negative is afoot, so they sell overnight. And when U.S. investors come in the next morning, they're spooked by the negative developments in Asia, which confirm their pessimistic inclinations, so they sell. This is a lot like the game of telephone we played when I was little: the message may be miscommunicated as it's passed down the chain, but it still encourages ill-founded actions.

When psychology is swinging radically, meaningless statements can be given weight. Thus, during the three-day decline earlier this month, it was observed that foreigners sold more Japanese stocks than they bought, and investors reacted as if this meant something. But if foreigners sold on balance, Japanese investors must have bought on balance. Should either of these phenomena be treated as more significant than the other? If so, which one?

Further complicating things in terms of rational analysis is the fact that most developments in the investment world can be interpreted both positively and negatively, depending on the prevailing mood.



"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."

Another classic cartoon sums up this ambiguity in fewer words. It's highly applicable to the market tremor that inspired this memo.

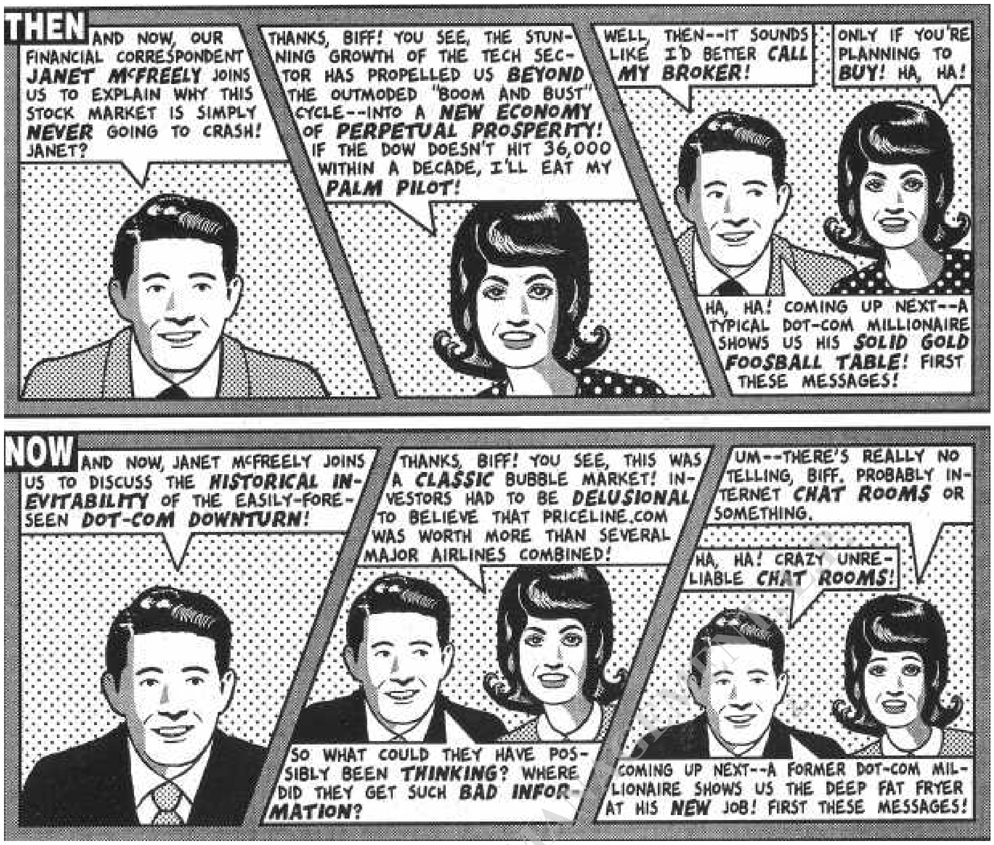
"Everything that was good for the market yesterday is no good for it today."

One more source of miscalculation is investors' tendency toward optimism and wishful thinking. Investors in general – and equity investors in particular – must, by definition, be optimists. Who other than people with positive expectations (and/or a strong desire for increased wealth) would be willing to part with money today based on the possibility of getting back more in the future?

Charlie Munger, Warren Buffett's late partner, routinely quoted the ancient Greek statesman Demosthenes, who said, **"Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true."** One great example is "Goldilocks thinking": the belief that the economy will be neither strong enough to bring on inflation nor weak enough to lapse into recession. Things sometimes work out that way – as may be the case right now – but not nearly as often as investors posit. Expectations that incline toward the positive encourage aggressive behavior on the part of investors. And if this behavior is rewarded in good times, still more aggressiveness usually ensues. **Rarely do investors realize that (a) there can be a limit to the run of good news or (b) an upswing can be so strong as to be excessive, rendering a downswing inevitable.**

For years, I quoted Buffett as having warned investors to temper their enthusiasm: "When investors lose track of the fact that corporate profits grow at 7% on average, they tend to get into trouble." In other words, if corporate profit growth averages 7%, shouldn't investors begin to worry if stocks appreciate by 20% a year for a while (as they did throughout the 1990s)? I thought it was such a good quote that I asked Buffett when he said it. **Unfortunately, he answered that he hadn't. But I still think it's an important warning.**

That inaccurate recollection reminds me of John Kenneth Galbraith's trenchant reference to one of the most important causes of financial euphoria: "the extreme brevity of the financial memory." It's this trait that allows optimistic investors to engage in aggressive behavior, untroubled by knowledge of what such behavior led to in the past. Further, it makes it easy for investors to forget past errors and invest blithely on the basis of the newest miraculous development.



Finally, the investment world might be less unstable if there were immutable rules – like the one governing gravity – that could be counted on to always produce the same results. **But there are no such rules, since markets aren't built on natural laws, but rather the shifting sands of investor psychology.**

For example, there's a long-running adage that says we should "buy on rumor and sell on news." That is, the introduction of favorable expectations is a buy signal, because expectations often continue to rise. That ends when the news arrives, however, because the impetus for gains has been realized and no further good news remains to take the market higher. But in the carefree environment of a month ago, I told my partner Bruce Karsh that maybe the prevailing attitude had become "buy on rumor and buy on news." In other words, investors were acting as though it was always a good time to buy. Rationally, one shouldn't price in the possibility of a favorable event twice: both when the possibility of the event is introduced and when the event occurs. But euphoria can get the better of people.

Another example of the absence of meaningful guidelines can be seen in this excerpt from one of the oldest clippings in my file:

> A continuing pattern of consolidation and group rotation suggests that increasing emphasis should be placed on buying stocks on relative weakness and selling them on relative strength. This would be a marked contrast to some earlier periods where emphasizing relative strength proved to be effective. (Loeb, Rhoades & Co., 1976)

In short, sometimes the things that have gone up the most should be expected to continue to go up the most, and sometimes the things that have gone up the least should be expected to go up the most. To which many of you might respond "duh." Bottom line: there are few effective rules for investors to follow. Superior investing always comes down to skillful analysis and superior insight, not adherence to formulas and guidelines.

*   *   *

Volatile psychology, skewed perception, overreaction, cognitive dissonance, rapid-fire contagion, irrationality, wishful thinking, forgetfulness, and the lack of dependable principles. That's quite a laundry list of ills. Together, they constitute the main cause of extreme market highs and lows and are responsible for the volatile swings between them. Ben Graham said that, in the long run, the market is a weighing machine that assesses the merit of each asset and assigns an appropriate price. But in the short term, it's merely a voting machine, and the investor sentiment that moves it swings wildly, incorporating little rationality and assigning daily prices that often reflect little in terms of intelligence.

Rather than try to reinvent the wheel, I'll repeat some of what I've said in two past memos:

> Especially during downdrafts, many investors impute intelligence to the market and look to it to tell them what's going on and what to do about it. This is one of the biggest mistakes you can make. **As Ben Graham pointed out, the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously.** Market participants have limited insight into what's really happening in terms of fundamentals, and any intelligence that could be behind their buys and sells is obscured by their emotional swings. It would be wrong to interpret the recent worldwide drop as meaning the market "knows" tough times lay ahead. (*It's Not Easy*, September 2015)
>
> My bottom line is that markets don't assess intrinsic value from day to day, and certainly they don't do a good job during crises. Thus, market price movements don't say much about fundamentals. **Even in the best of times, when investors are driven by fundamentals rather than psychology, markets show what the participants think value is, rather than what value really is.** Value is something the market doesn't know any more about than the average investor. **And advice from the average investor obviously can't help you be an above average investor.**
>
> Fundamentals – the outlook for an economy, company or asset – don't change much from day to day. **As a result, daily price changes are mostly about (a) changes in market psychology and thus (b) changes in who wants to own something or un-own something.** These two statements become increasingly valid the more daily prices fluctuate. Big fluctuations show that psychology is changing radically. (*What Does the Market Know?*, January 2016)

The market fluctuates at the whim of its most volatile participants: those who are willing (a) to buy at a big premium to the former price when the news is good and enthusiasm is riding high and (b) to sell at a big discount from the former price when the news is bad and pessimism is rampant. Thus, as I wrote in *On the Couch*, every once in a while, the market needs a trip to the shrink.

It's important to note that, as my partner John Frank points out, in comparison to the total number who own each company, it takes relatively few people to drive prices up during bubbles or down during crashes. When shares in a company that was worth $10 billion a month ago trade at prices implying a valuation of $12 billion or $8 billion, it doesn't mean the whole company would change hands at these prices; just a tiny sliver. **Regardless, a few emotional investors can move prices much more than should be the case.**

The worst thing you can do is join in when other investors go off on these irrational jags. It's far better to watch with bemusement from the sidelines, buttressed by an understanding of how markets work. **But better still to see Mr. Market's overreactions for what they are and accommodate him, selling to him when he's eager to buy regardless of how high the price is, and buying from him when he desperately wants out.** Here's how Ben Graham followed the introduction of Mr. Market that I included on page 1:

> If you are a prudent investor or a sensible businessman will you let Mr. Market's daily communication determine your view of the value of your $1,000 interest in the enterprise? Only in case you agree with him, or in case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position.

In other words, it's the primary job of the investor to take note when prices stray from intrinsic value and figure out how to act in response. Emotion? No. Analysis? Yes.

August 22, 2024

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Memo to: Oaktree Clients

From: Howard Marks

Re: Shall We Repeal the Laws of Economics?

For months, I've been saving up clippings for a memo on the above topic, but favorite subjects such as risk, debt, and uncertainty repeatedly jumped the queue, delaying my intended memo until the U.S. election season got into full swing, making it compelling.

Like me, you've undoubtedly noticed that politicians ranging from former President Trump and Vice President Harris to down-ballot candidates are back to making promises that ignore economic reality. Trump's call for tariffs and Harris's attack on grocery profiteering are merely two examples of proposals that would impose costs the candidate ignores (in Trump's case) or that fail to reflect a meaningful understanding of the problem (in Harris's case). My purpose, of course, is not to promote or dismiss either candidate, but rather to illustrate that there is no "free lunch" in economics, despite candidates' assertions to the contrary.

The Background

In 2016, with an unusually clamorous presidential election in full swing, I published two memos that strayed from investing into the world at large, called *Economic Reality* and *Political Reality*. The first explained that economics is largely the study of how we make choices – how people allocate finite resources among the available options. The second stated that in politics – and especially in the land of campaign promises – there's no such thing as finiteness. As I wrote in *Political Reality*:

> I've always gotten a kick out of oxymorons – phrases that are internally contradictory – such as "jumbo shrimp" and "common sense." I'll add "political reality" to the list. The world of politics has its own, altered reality, in which economic reality often seems not to impinge. No choices need be made: candidates can promise it all. And there are no consequences. If something might have negative consequences in the real world, politicians seem to feel free to ignore them.

I followed those two memos with one in 2019 entitled *Political Reality Meets Economic Reality*. **Its main thrust was that politicians can promise whatever they want regarding the economy, but they won't be able to deliver if their promises fly in the face of economic reality because, ultimately, the laws of economics are incontrovertible. Free economies are driven by self-interested decisions made by millions of producers and consumers, employers and employees, and savers and investors. Governments can pass laws designed to encourage or even compel behavior, but in general they can't mandate economic outcomes. There are so many moving pieces and second-order consequences that governments generally can't engineer both prosperity and the specific economic outcomes that policymakers may seek.**

History is littered with command economies that didn't succeed. There's proof for this that includes the "control group" required by the scientific method. Eighty years ago, Korea was a single country. Then, following World War II, it was split in two, obviously with similar people, geography and resources: South Korea (under U.S. influence), and North Korea (under Soviet influence). Since then, South Korea has operated as a capitalist democracy and North Korea as a communist dictatorship. There's little reliable economic data regarding North Korea, but according to the CIA's *Worldbook*, its GDP in purchasing power terms is estimated at $2,000 per person versus $50,000 in South Korea. North Korea's citizens are described as impoverished, but at least it doesn't have a border problem, since nobody's trying to sneak in. There are political differences (democracy versus dictatorship) in addition to the economic ones, but **I think it's fair to say capitalism has won**.

In discussions of economic systems, I usually ask people what they think has been responsible for the economic preeminence the U.S. has enjoyed since the end of World War I, and thus for its citizens' higher average standard of living. Are Americans smarter? Harder working? More deserving? None of the above. I'm confident it's because of our historical embrace of the free-market system and capitalism.

The incentives provided by free markets efficiently direct capital and other resources where they'll be most productive. They prompt producers to make the goods people want most and workers to take the jobs where they'll be most productive in terms of the value of their output. And they encourage hard work and risk taking. The result is a higher standard of living for society in general, but certainly not everyone benefits to the same degree. Thanks to the way incentives interact with people's different abilities, some people do considerably better than others. Some also prosper thanks to good luck and/or inherited advantage, rather than innate ability. **The free-market system doesn't necessarily produce "fair" outcomes in all circumstances, but economic systems designed to do so generally don't provide the incentives needed to encourage economic productivity for the collective good. That's what accounts for their record of failure.**

On August 15, the media reported that the next day, Vice President Harris would announce her economic policies. The bulk of the attention went to her promise to ban price gouging in the grocery industry. "Grocery prices … have jumped 26 percent since 2019, according to Elizabeth Pancotti, director of special initiatives at the Roosevelt Institute, a left-leaning think tank" (*The Washington Post*, August 15), and many voters say inflation is their greatest concern. For this combination of reasons, Harris's targeting of grocery prices is entirely predictable. (Ironically, August 15 was also the day U.S. inflation was reported to have fallen below 3% for the first time since March 2021.) I'm certain, however, that this falls under the heading of simplistic economic solutions that are designed to appeal to voters but are unsoundly based and likely to fail.

<u>What Is Price Gouging?</u>

Price gouging is generally defined as sellers taking advantage of market power or temporary supply/demand imbalances to raise prices to levels that otherwise wouldn't prevail. And food prices did rise significantly in 2021 and 2022, leading to suspicion of food retailers. But might there be reasons for the price increases other than a malevolent decision to gouge on the part of sellers? Here are a few possibilities:

- When the pandemic began in March 2020, most people stayed home and cooked their own meals, significantly increasing the demand for groceries and depleting inventories.
- The production system was disrupted, with inputs in short supply or in the wrong places relative to the needs. This led to the much-discussed "supply-chain problems." Too few goods – when coupled with too much money chasing them – constitute the classic reason for inflation.
- The federal government sent taxpayers massive amounts of Covid-19 relief. Many more people received benefits than had been hurt financially by the pandemic. Those people came out ahead, capturing trillions of dollars for future spending.

- When the Delta variant of Covid popped up in mid-2021, people again stayed home and shrunk from contact with others, spending more on goods and less on services than they otherwise might have. Demand for goods was strong as a result, outstripping the limited supplies and causing prices to rise.

Profit margins in the supermarket industry are low – about 1% to 2% of sales – and that changed only a little in 2021-22. So, was there gouging? And if gouging is the explanation for the price increases, why did it occur in those years, rather than sooner? Again, might today's high prices be explained by something other than gouging? *The New York Times*, rarely a defender of capitalism, wrote the following on August 15:

> Researchers from the Federal Reserve Bank of Kansas City reported last year that rapid job growth in the U.S. economy, and the wage increases that came with it, were major contributors to rising grocery prices.

A number of factors contributed to the increase in food prices, many of them linked to the macro economy. **But the bottom line is that conditions allowed food sellers to raise prices, and they did so.**

Is Raising Prices Wrong?

The above is the key question. Definitions of price gouging invariably include words like "unfair," "excessive," and "exorbitant." These are subjective terms that are open to judgment and debate. The propriety of behavior with regard to these words is usually in the eye of the beholder. The seller's highly reasonable price increase is the customer's gouging. The difficulty of defining gouging reminds me of those who say, "we're not out to soak the rich; we just want to make them pay their fair share in taxes." I'm far from saying the rich shouldn't pay their "fair share," but what's the standard for a fair share, and who gets to set it? **In the same way, who determines whether prices are fair, and how?**

When a supermarket raises the price of a necessity like bread, is that gouging? The answer is that it's complicated, and that's what makes it hard to regulate prices fairly.

- If the farmer pays more for fertilizer and labor and then charges the baker more for wheat, can the baker fairly pass that on to the supermarket in the form of a higher price for bread?
- If the baker raises the price he charges the supermarket for bread, is it wrong for the supermarket to pass on the increase to the consumer?
- If the supermarket's employees demand higher pay, can it offset the increase by raising the prices of the things it sells?
- If demand increases because a hit TV show popularizes sandwiches, is it wrong for people in the supply chain to take advantage and charge more for bread?

In a free market, prices are determined by supply and demand. Is it wrong per se for providers of goods and services to raise prices in response to reduced supply or increased demand? A few examples should make clear the complex nature of this question.

- Uber applies "surge pricing" during rush hour, when more people want rides. Is that an unfair practice? If the government says Uber mustn't do so, that will make rides available at prices below what some people would pay and deprive drivers of the full fare they could otherwise collect. And the rate the drivers would then receive might not be high enough to justify the time they'd spend stuck in traffic, meaning fewer drivers would be available to handle the peak demand and people needing rides would remain unserved. **Is that preferable?**

- If 1,000 tickets for a Taylor Swift concert are put on sale at $100 and 3,000 people line up to buy them, what's the message? Simple: they're too cheap! Would it be unfair for the concert promoter to raise the price until there are just 1,000 people in line? Few people would say so. But if instead the price remains at $100 and the first 1,000 people buy them all, that leaves unmet demand, in which case those who bought the tickets would be able to resell them for more than $100. The profit would go to the resellers, who got their tickets at a price that was too low. Is that fair? **Wouldn't it be fairer if the ticket prices were raised and the increment went to Tay Tay, reflecting the full value her fans put on her labor?**
- In 2021, when people wanted to leave their city apartments, and homes and building materials were in short supply, home prices shot upward. If you owned a home worth $400,000 in 2019 and asked $500,000 for it in the post-pandemic environment, was your behavior immoral? **Should the government prosecute people who asked more for their homes?**
- Lastly, when the economy sprung back to life in 2021 and there were multiple job openings per unemployed worker, making higher salaries attainable, workers were able to tell the boss, "I can get a higher salary down the road. If you don't give me a raise, I'm leaving." Should the government limit wage increases at a time when employees have an edge in negotiations? In the fall of 2023, the United Auto Workers union took advantage of the bargaining power caused by the tight labor conditions to extract from Ford "an 11% wage increase in the first year, and total 25% increase in wages over the 4.5 year contract, a $5,000 ratification bonus and a cost-of-living adjustment." (Wikipedia) **This was a huge package. Did it represent gouging?**

Each of these examples shows one party taking advantage of supply/demand conditions to charge more for the thing they have to offer. But certainly, their actions aren't illegitimate. They're simply examples of how markets work.

The alternative would be to have the government decide who should prevail in each case. Should it be the Uber driver or the passenger; the concertgoer or the performer; the homeowner or the homebuyer; the worker or the employer? Many have a knee-jerk tendency to sympathize with the passenger, concertgoer, homebuyer, and worker, as it's easy to care less about the person who's profiting: the driver, popstar, homeowner, and employer. **But if the government puts its thumb on the scale in favor of one party or the other, it distorts the workings of the free market and keeps it from functioning efficiently on behalf of society overall.** More on this later.

There are forms of seller behavior that are clearly wrong. These include collusion, price fixing, and predatory pricing designed to drive competitors out of the market. But laws prohibiting these behaviors are already on the books. Additional laws designed to prohibit and punish price increases that someone *views* as unfair, excessive or exorbitant – as opposed to being the result of improper conduct – are sure to prove difficult to enforce and counter-productive.

Would a Law Against Price Gouging Work?

Just as history is full of failed command economies, it also shows the ineffectiveness of attempts to regulate prices. In 1974, when the OPEC oil embargo set off inflation that made life difficult for millions, the U.S. government countered by distributing "WIN" buttons, standing for Whip Inflation Now. I still have mine, but neither it nor the voluntary consumer actions that were supposed to follow were enough to keep inflation from reaching 13.5% in 1980. The buttons were derided, with some skeptics wearing them upside down, according to Wikipedia. "Worn that way, 'NIM' stood for 'No Immediate Miracles,' 'Nonstop Inflation Merry-go-round,' or 'Need Immediate Money.' "

There's more recent experience with price controls, in Venezuela. Here's what I said about it in *Economic Reality*:

> A case in point is the price controls, which have expanded to apply to more and more goods: food and vital medicines, yes, but also car batteries, essential medical services, deodorant, diapers, and, of course, toilet paper. **The ostensible goal was to check inflation and keep goods affordable for the poor, but anyone with a basic grasp of economics could have foreseen the consequences:** When prices are set below production costs, sellers can't afford to keep the shelves stocked. Official prices are low, but it's a mirage: The products have disappeared. (*Atlantic Monthly*, May 12, 2016, emphasis added)

> **Here's a shocker: you can set prices for goods, but you can't make people produce them.** That sounds a lot like economic reality.

This is an example of the fact that officials may believe they can control economic developments with a stroke of the pen, but they'll be thwarted by second-order consequences that complicate the effort.

There's nothing wrong with trying to bring down the cost of necessities. However, the best way to do this is to encourage additions to supply. Another way is to not overstimulate demand by injecting excessive liquidity into the economy. **Mandating lower prices is generally the least effective way to get them.**

This is a good time for me to cite the economist's adage that "the best solution for high prices is high prices." This isn't a joke; far from it. In general, high prices mean demand is strong relative to supply. Eventually, those high prices will encourage producers to produce more and consumers to consume less, and the depressant impact on prices from both directions is obvious. We see this all the time in the oil market, for just one example.

A government bureaucracy set up to regulate the price of food is very unlikely to succeed and almost certainly would have adverse effects. So, are there no benefits we can count on from price controls? I can think of one: thousands of new (albeit unproductive) jobs in that new bureaucracy. As Jason Furman, a relatively liberal economist, said of Harris's anti-gouging efforts, "This is not sensible policy, and I think the biggest hope is that it ends up being a lot of rhetoric and no reality."

<u>Another Case in Point: Rent Control</u>

The issue that first suggested this memo several months ago was rent control, something I've had personal experience with, having lived in an apartment that rented for $92 a month in 1956, when I was ten.

The federal government implemented rent control during World War II so that, with few new apartment buildings being built and breadwinners away fighting the war rather than earning their normal wages, families wouldn't be priced out of their apartments. Rents on New York City apartments were frozen at 1943 levels. This was probably a good idea under the unusual circumstances of wartime, but the program wasn't dismantled afterwards, and it still governs some apartments that were built more than 80 years ago. And rent regulation still plays havoc with the supply and demand for New York City apartments.

In general, New York City rent control limits rent increases on apartments so long as they're occupied by people who were tenants in 1971 or relatives who lived with them. The law was enacted to protect the occupants at the time, but apartments have been passed down at controlled rents to people who didn't necessarily live in them in 1971. Fewer and fewer people are still around who satisfy the above criterion, so this form of rent regulation is winding down.

Newer regulations continue in force under the rubric of "rent stabilization." One example is Mandatory Inclusionary Housing, which has been explained to me as follows: if you want to build an apartment building and need some zoning relief – and virtually all projects do – you must agree as follows:

- A percentage of the apartments will be "affordable."
- Tenants for affordable apartments must earn incomes well below the average in the area.
- The maximum allowable rent will be set based on a percentage of tenants' income.
- Rent increases upon lease renewal will be regulated, usually at a few percent per year.

Most would agree that it's laudable to encourage the creation of new affordable apartments, but this particular method of doing so has the related effect of increasing the cost of apartment construction. Probably everyone would be better off if there were simply more new apartments built every year.

The bottom line is that rents for the majority of New York City apartments remain subject to one form of control or another and are unlikely to ever become fully deregulated. As a result, the incentives to build new apartments are limited, and between 2002 and 2017, for example, the growth in the number of rental apartments in New York City was only 0.3%, per year.

Improvements in regulated apartments are also regulated. Expenditures on improvements are limited to a very small amount in any 15-year period, and the investment can be recouped only through an increase in the monthly rent equal to a tiny percentage of the cost of the improvements. Thus, making improvements is generally uneconomic:

> Many landlords do not fill their vacant rent stabilized units, as the operational and renovation costs may exceed the legal maximum rent. As of 2022, there are roughly 20,000 vacant rent stabilized apartments in New York City. (Wikipedia)

Might there be something wrong with a system where (a) there's strong demand for apartments but (b) it's more profitable to keep apartments vacant than rent them out? **Apartments aren't much different from bread or toilet paper. Officials can limit the price people have to pay, which is popular with consumers, but other than in the most dictatorial jurisdictions, they can't force suppliers to produce goods for sale at the regulated prices.**

As I've tried this year to keep up with articles about New York's apartment situation, I've noticed that the following factors are usually listed as discouraging apartment creation: (a) a lack of tax incentives and subsidies, (b) resistance to construction of affordable apartment buildings in the suburbs, and (c) high interest rates (albeit the last one can't be used to explain the low level of apartment construction in the 2010s). **What struck me most was the absence of any mention of the impact of rent regulations.**

A February 9 article in *The New York Times* particularly piqued my interest. The article reported that the percentage of New York City rental apartments that were "vacant and available" had fallen to 1.4%, the lowest since 1968. It went on to say, "Housing experts consider a healthy vacancy rate to be somewhere around 5 to 8 percent." So why are so few apartments vacant? It comes down to supply and demand:

a) As in the example of Taylor Swift tickets, **they're simply too cheap**. That means demand is strong and apartments don't sit vacant.

b) Also, because rents are kept too low, **would-be builders can't achieve attractive returns**, meaning there are few additions to supply. (I also imagine that if apartment builders could earn an acceptable return on investment, they'd have to worry about new regulations expropriating it.)

As mentioned earlier with regard to prices in general, if demand for apartments is strong and supply is restricted, the result should be rents that rise, encouraging landlords to add to supply. But market forces aren't allowed to freely function in New York City; the laws of economics have been blunted by regulation. The February 9 article included the following statements (and this is from *The New York Times*, again usually not the capitalist's friend):

> The answer is that developers generally can't make returns for building apartments that are competitive with the returns on other forms of investment. . . .
>
> Housing experts estimate that the number of homes the city needs to build is in the hundreds of thousands.
>
> So far, however, the city and state have not made moves that could accelerate enough housing development to solve the crisis. . . .
>
> [Governor Kathy] Hochul said in a statement that the survey was "the latest reminder that we can only build our way out of this crisis."

But it's interesting to note that the "moves" that are described as having the potential to lead to "building our way out of this crisis" always emphasize government-provided subsidies and incentives, never allowing the free market to set rents.

A person in favor of this arrangement would argue that it maintains affordability and diversity. **What it means in purely economic terms is that some people who couldn't afford to live in New York City if rents were set by free-market forces are able to live there if they're lucky enough to secure an apartment with regulated rent. But other people who would like to live in New York City and can afford higher rents can't do so because there are no apartments for them.** And lastly, landlords that have apartments that are somehow unregulated can command higher rents than would be the case if additions to the supply of apartments weren't being discouraged. It's a matter of personal philosophy whether this is good or bad. But clearly, the laws of economics and the actions of free markets aren't at work in New York City. Someone in government is making the decisions.

I'll end this discussion with a comment Jason Furman made about grocery prices:

> Mr. Furman . . . said . . . if prices do not rise in response to strong demand, new companies may not have as much inclination to jump into the market to ramp up supply. (*The New York Times*, August 15)

By the way, as part of her August 16 economic package, Harris said she would prohibit landlords who own more than 50 apartments from raising rents by more than 5% for two years. That may or may not be a good idea, but it's certainly not going to encourage increased investment in apartments.

<u>Regulatory Miscellany</u>

There are so many examples of governmental attempts to ignore or override the laws of economics that it's daunting to think of cataloging them, but I must discuss a few here, and their shortcomings:

- Another component of Harris's economic program is a plan to **give first-time homebuyers $25,000 to help with down payments**. Certainly, it's hard these days for young people to come up with the cash needed to become homeowners. The problem here is that giving a million would-be buyers $25,000 each, or $25 billion in all, would almost certainly result in an immediate increase in home prices, eliminating much of the hoped-for benefit from the program. Easy: that can be prevented by passing a law that prohibits current sellers from raising home prices in response to enactment of the program. But what about homes that will come onto the market in the future? Simple: enact another law that says you can't ask more for your home than you would have if the program didn't exist. Try enforcing that one.

- When he was president, Donald Trump enacted tariffs on goods from China to counter trade practices he considered unfair. Now, he promises **a 10% across-the-board tariff on imports**. Those tariffs might discourage imports, stimulate domestic production, and reduce the U.S.'s chronic trade deficit. But they'd likely be paid by consumers of imported goods, as manufacturers and exporters are unlikely to absorb a tariff if they can pass it on. For many years low-cost imports have held down inflation in the U.S. and enabled Americans to enjoy an attractive standard of living. Broad new tariffs are likely to be the equivalent of price increases for American consumers. And the tariffs – and those imposed by other nations in retaliation – would hamper globalization, which benefits the global economy by letting people in each nation do for the world what they're best at.

- Trump's policy proposals also include **extension of his expiring 2017 tax cuts and a panoply of new ones**. There's something for everyone, with tax cuts for corporations and individuals, including ending the taxation of tips, Social Security benefits, and overtime pay. The Penn Wharton Budget Model estimates that in 2026, the plan would reduce taxes by $320 for the average person in the bottom income quintile and $47,220 for those in the top percentile. Even without factoring in the latest proposals, like exempting overtime pay, these actions are projected to increase the national deficit by $5.8 trillion over the next decade, or $4.1 trillion after incorporating their potential stimulative impact on the overall economy (so-called "trickle-down effects"). Other than that possibility, there's no suggestion the cuts would be paid for.

- California is a Petri dish for so-called "progressive" economic ideas. In 2022, the state legislature passed a bill creating a council comprised of industry representatives and restaurant workers to set wages in the fast-food industry. Faced with a threatened industry-financed referendum to repeal the law, legislators modified it to mandate **a minimum hourly wage of $20 for fast food chains of more than 60 restaurants**. The new law only took effect in April, so it's too early to assess its impact. Press accounts, however, are replete with accounts of restaurants closing, employees being laid off or having their hours reduced, employers investing in labor-saving technologies, and substantial price increases for the consumer. Although "mom and pop" restaurants are not required to pay the new minimum wage, predictably many have been forced to match the mandated rate to retain their employees, meaning the protection legislators intended for small restaurants may be illusory. That's how the laws of economics work.

- Similarly, California passed a law mandating a **$25-an-hour minimum wage for workers in the healthcare industry.** But more recently, according to *The Wall Street Journal* of May 27, officials realized that it "would cost the state $4 billion more a year owing to higher Medicaid costs and compensation for workers at state-owned facilities" and so they delayed the benefit of the law with respect to those workers. Shocking here is the idea that you can't give money to someone without getting it from someone else, and California taxpayers might not enjoy the state directing more of it to healthcare workers, especially given the current budget deficit.

- If there's one thing both parties agree on, it's **"hands off Social Security!"** Retirees present and future want their monthly payments, and they want the rules left as they are. The leaders of both parties have agreed to this. It's just that it can't work. Social security is a contributory program analogous to insurance, and it works through a trust fund. Workers pay in via taxes and retirees get checks. But the number of retirees drawing benefits has been growing relative to the number of active workers paying in, and, if nothing is changed, the fund is sure to become insolvent through an inexorable mathematical process. There are many levers that could be pulled to restore Social Security to health, but nobody wants to pull them, since doing so would displease someone (that is, displease some voters). The options include (a) raising the Social Security tax rate, (b) raising the ceiling on the earnings on which tax is paid, (c) reducing benefits, (d) limiting cost-of-living adjustments, (e) raising the retirement age, (f) limiting the number of years for which retirees can collect, and (g) means testing would-be recipients. None of these is considered acceptable. Everyone just wants their checks as promised.

  It doesn't take a degree in economics to know what happens when people spend more than they bring in. (Only in political reality might someone expect a different outcome.) However, we don't hear a word from politicians or elected officials about making the changes that are necessary to keep the Social Security trust fund from insolvency. The government can switch Social Security from a self-funded program to a government-funded benefit, of course, and at first glance, the change appears to be mainly semantic. But depleting the trust fund and paying benefits from the Treasury would add further to the already-troublesome deficit, the national debt, and the annual debt service, which would feed back to further increase the deficit and debt.

That leads me to a topic I'm asked about all around the world: the U.S. government's deficit and debt. I answer that they're an embarrassment. Oaktree is privileged to manage money for several countries that have sovereign wealth funds, not national debt. Some countries put windfalls into a lockbox, like Norway's oil revenues or the proceeds from the privatization of Australia's telephone company. And many other countries live within their means simply because they have to – they don't have the luxury of printing unlimited amounts of money without precipitating a devaluation. But the U.S. habitually runs deficits, spending more than it takes in. Our last surplus came in 2000, at the end of the Clinton administration. Today, for the first time, simply the annual interest on our national debt exceeds the Defense Department budget. Yet neither party is willing to address the deficit or stand for balanced budgets. Our congress rarely submits a budget at all, no less a balanced one. **This is irresponsible behavior we wouldn't tolerate in our own organizations.**

The U.S. acts as if it has a credit card with no limit on the balance and no requirement to pay it down. It does so because it's been able to get away with it thus far, and our governing officials lack the will to spend less than they can. We don't hear much these days about Modern Monetary Theory, the view popularized in 2020 that "for countries in control of their currencies, deficits and debts don't matter." Nevertheless, our government still acts as if this theory is valid.

In the 1930s, John Maynard Keynes posited that when an economy is growing too slowly to produce the needed jobs, the government should increase spending to stimulate demand, even if that means running a deficit and covering it by borrowing. And then, when prosperity resumes and the jobs are there, it should spend less than it takes in, running a surplus and using it to repay the debt. All good, except for that last bit: the part about surpluses and debt repayment has been forgotten.

The truth is, deficits encourage the economic growth that most people enjoy, and spending more than the government takes in permits officials to give away "free stuff," thereby gaining votes. **But doing this**

perpetually requires ignoring the laws of economics, running up debts in the apparent belief that they'll never have to be paid. Can it go on without end? We'll see, but I would think not.

<u>What Are the Common Threads?</u>

The actions and proposed actions described above, like the questions beginning at the bottom of page three, all have certain elements in common.

- The goals usually seem commendable on the surface: cheaper goods and services, and more equal outcomes. But, given the way things work in economics, they usually have second-order consequences that are uncontrollable and unhelpful.
- At their core, they're all questions of "who gets what?" There's no possibility of money appearing from out of the ether; there are just choices regarding who pays in and who gets something out. It's a zero-sum game.
- The goals are often populist, with legislators and regulators picking winners and losers. They usually fashion their actions as protecting the downtrodden little guy from the rapacious big guy. Most anti-free-market regulations incorporate size criteria, meaning they only apply to supermarkets, not corner grocery stores; landlords with a lot of apartments; medical facilities of a certain size; and restaurant chains, not independents. In this context, we should note what President Biden said at the Democratic National Convention in August: "I'm proud to have been the first president to walk a picket line and be labeled the most pro-union president in history." Are employees per se more deserving of protection than employers? Without employers, where would people get jobs? Regardless, they do serve as convenient targets for politicians.
- The rhetoric surrounding these matters is often alarmingly classist and divisive. Here's part of a typical note I received from a candidate last month: "Even with inflation lowering [sic], food prices still seem sky-high. It's another sign of corporate greed hurting . . . consumers. CEOs shouldn't be lining their pockets with record profits while families struggle to put food on the table or pay for medications." In this kind of environment, "profit" is a dirty word, and "greedy corporations" are ripe for suspicion and regulation.
- Finally, elected officials have a habit of exempting themselves from impact. Thus, it's interesting to observe that California's minimum fast-food wage doesn't apply to restaurants in government facilities. What official wants to suffer the wrath of an employee forced to pay more for lunch?

One of the most important characteristics of the laws of economics is that they apply to everyone. On the other hand, attempts to negate those laws are usually designed to affect some parties differently from others. Whenever this is the case, those in charge are picking would-be winners and losers. Not a great idea in a "free society."

Fundamentally, government subsidies and economic regulations amount to encouraging actions that people wouldn't take on their own. In other words, these actions wouldn't happen in a free market. Mandates like these should be examined critically. Some may stem from officials' Solomonic decisions and desire for a fair society. Others are probably the result of a philosophic bias in favor of redistribution. And still others are just a matter of currying favor with voters.

For many career politicians, the first order of business is getting elected and reelected. Elected officials' tinkering with the economy is often designed to appeal to voters. Then there's the added benefit of getting officials off the hook, since they can redirect blame for politically undesirable developments to "bad actors," such as powerful corporations and greedy landlords. Finally, economic regulations can provide temporarily palliative outcomes, with the negative side effects coming only in later years, when the officials who enacted them have left the political stage.

Free Markets or Controlled Markets? That Is the Question

Governments don't make a product, create value over and above the cost of the inputs they employ or – other than through their spending – contribute to GDP. They collect (or print) money with one hand and distribute money and services with the other. They collect taxes from taxpayers and incur debts in the name of future taxpayers. Then they pay out money for benefit programs, salaries, capital expenditures, and subsidies. **Policymaking is about who will pay in and who will receive the benefits.**

Governments don't strive for profits, meaning the people who run governments get a free pass on efficiency. Corporate management teams that fail to produce a product worth more than the inputs – aka make a profit – won't last long. But governments aren't expected to do so, and as a result, there's no easy yardstick for quantifying a government's effectiveness, like profits do for a business.

Governments do play essential roles that may have nothing to do with profits or value added.

- They provide things people can't provide for themselves, such as defense, healthcare, police and fire services, education, infrastructure, and response to emergencies, both physical (floods, tornados, and pandemics) and economic (recessions and hyperinflation).
- They also provide safety nets for those who would otherwise suffer. There are extensive differences of opinion over how much of this governments should do, and those differences underly one of the biggest disagreements between the U.S. political parties.

Beyond necessities, how far should a government go to even out its citizens' incomes and quality of life? Doing so is one of the reasons why governments take from some to give to others as described above. **But it must be acknowledged that each step in this direction – as opposed to requiring people to fend for themselves – is a step in contravention of free-market forces, with consequences.**

- Darwin described the way species are strengthened through what is known as "survival of the fittest." It works, and species evolve upward. But this is, by definition, a cold-blooded process through which the strong thrive and the weak perish. Good for the whole of the species, but not for every member.
- Likewise, the collective economic welfare of a society is maximized by the operation of the free market. In the process, some people do better than others – preferably, but certainly not always, the most talented, hardest working, and most deserving. Only in the most rose-colored (and ill-fated) systems is it not accepted that some people will do better than others. But the differential has expanded a great deal of late, and there is a growing debate as to "how much better" is fair and acceptable.

<u>The choice is clear based on the evidence provided by history: (a) efficient free market economies with their incentives and uneven outcomes or (b) command economies with their uniform outcomes and sub-par performance.</u> On page two, I wrote the following:

> The incentives provided by free markets direct capital and other resources where they'll be most productive. They prompt producers to make the goods people want most and workers to take jobs where they'll be most productive in terms of the value of their output. And they encourage hard work and risk taking.

In contrast, if markets are made less free – that is, if they're forced to follow government edicts rather than the laws of economics:

- capital and raw materials will be directed to places other than where they'll be most productive;
- producers will fail to make the things people want most, and instead will make things the government thinks people should have;
- workers will be assigned to work where they'll produce less than they otherwise might; and
- hard work and risk taking won't take place as much, since the rewards for doing those things will be capped and, in some cases, redirected to people who didn't do the work or take the risk but whom those in control deem deserving.

Incentives and free markets are essential for a high-functioning economy, but their existence assures that some members of the economy will do better than others. You can't have one without the other.

China

At this point you might ask, "But what about China? The Chinese economy isn't free to operate pursuant to the laws of economics, but it's doing well." We think of China as a "communist country," replete with state-owned enterprises, industrial policy, and five-year plans. And yet, China's GDP has grown at nearly 9% per annum for the last 45 years, and in 2010 it became the world's second-largest economy. How could that be?

As it turns out, much of China's economic success is attributable to a vibrant private sector. I've been visiting China for nearly 20 years and, especially during my early visits, I struggled to comprehend the logic that permits the coexistence of the collective ideology with private enterprise. Certainly, those are "strange bedfellows." A visit to Xiamen, China earlier this month for the China International Fair for Investment & Trade reminded me of this conundrum. Regardless of the explanation, the fact is that China's economy relies heavily on the dynamic private sector. In the summer of 2022, Edward Cunningham of the Harvard Kennedy School used a popular formulation to describe it:

> China's private sector is often summed up with a combination of four numbers: 60/70/80/90. Private firms contribute 60% of China's GDP, 70% of its innovative capacity, 80% of its urban employment and 90% of new jobs.

And the government recognizes this. On March 13, 2023, CNN reported on a statement from Chinese Premier Li Qiang:

> "For a period of time last year, there were some incorrect discussions and comments in the society, which made some private entrepreneurs feel worried," Li said Monday. "From a new starting point, we will create a market-oriented, legalized and internationalized business environment, treat enterprises of all types of ownership equally, protect the property rights of enterprises and the rights and interests of entrepreneurs."

Certainly, this represents a triumph of pragmatism over ideological purity. It's a clear example of accommodating to economic reality rather than trying to override it.

*   *   *

My first step toward understanding the workings of the various economic systems came in junior high school in the late 1950s, when I read George Orwell's *Animal Farm*. Orwell wrote it in 1945 as a thinly veiled critique of Russia and communism/socialism. That book taught me most of what I needed to know about free markets versus command economies. If you haven't read it, or if you read it so long ago that you can't remember what it says, I suggest you pick it up.

In the allegory of *Animal Farm*, the animals took over the running of the farm. For me, the key lesson emanates from the motto they painted on the barn wall, borrowed from Karl Marx: "From each according to his ability; to each according to his needs."

What an idealistic statement! It would be great if everyone produced all they could, with the more able members of society producing more. And it would be great if everyone got what they need, with needier individuals getting more. But, as the animals on the farm soon learned, if workers only get to keep what they need, there's no incentive for the more able among them to put in the additional effort required to produce a surplus from which to fill the needs of the less able. **The great challenge, of course, is to strike the proper balance: to take enough from the successful in the form of taxes to fund services, government programs, and wealth transfers without eroding their incentive to work or encouraging them to seek out low-tax jurisdictions.**

What I discuss above are the economic facts of life, and some of their ramifications may be less than ideal. But idealists' wishes don't govern economies; these realities do. Foremost among them are the power of incentives and the influence of supply and demand. The rules must be respected; they can't be ignored, wished away, or overridden without consequences.

Anyone who thinks it's better to live in a centrally planned economy that prefers evenly distributed benefits over free markets hasn't studied history (or read *Animal Farm*). It may sound good in theory, but it has never worked. The laws of economics will always win out eventually. Nations can respect them and reap the associated benefits, or they can try to contravene them and pay the price in terms of underperformance. **In the world of politics, there can be limitless benefits and something for everyone. But in economics, there are only tradeoffs.**

September 19, 2024

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Memo to: Oaktree Clients

From: Howard Marks

Re: Ruminating on Asset Allocation

When I travel to see clients and spend entire days discussing investing and the markets, memo ideas often pop up. Last month's visit with clients in Australia is a case in point. We talked about the "sea change" I believe is taking place in interest rates and about the role of credit in portfolios, and in a few cases, this led to the general topic of asset allocation. The result wasn't a lot of new ideas on the subject, but rather a new way to combine old ideas into a unified theory.

Before I proceed, I want to mention that, from time to time in this memo, I'll say "generally," "usually," or "everything else being equal." These caveats are likely applicable to many more sentences and ideas herein, but for the sake of readability, I'm not going to repeat them *ad nauseum*. In addition, I'm going to use a lot of graphics, as I truly believe one picture is worth a thousand words. Please bear in mind that these representations are intended to be notional, not technically correct.

<u>Asset Classes</u>

From my vantage point, "asset allocation" is a relatively new thing. No one used that phrase when I joined the industry 55 years ago. Structuring portfolios was a pretty simple matter, generally following the classic "60/40" split. Most U.S. investors limited themselves to investing in U.S. stocks and bonds, and there was a time-honored notion that something like 60% equities and 40% bonds represented reasonable diversification.

Today, investors are presented with so many choices – and there's so much emphasis on getting the decision right – that the term "asset allocation" is very prominent, and there are individuals and whole departments dedicated to doing just that. It's their job to decide how to weight the asset classes to be held in a portfolio, meaning asset allocators spend their time on decisions like these:

- How much in equities and how much in debt?
- How much in stocks and bonds and how much in "alternatives"?
- How much in public securities and how much in private assets?
- How much in one's home country and how much abroad?
- How much of the latter in the developed world and how much in emerging markets?
- How much in high quality assets and how much in low quality?
- How much in more volatile "high beta" assets and how much in steadier ones?
- How much in levered strategies and how much unlevered?
- How much in "real assets"?
- How much in derivatives?

It's enough to make your head spin. Many investors use computer models to help with these decisions, but the models require inputs regarding expected return, risk, and correlation, and most of these are based on history and thus of questionable relevance to the future. Correlation between asset classes is particularly difficult to predict. It's often a case of garbage in, garbage out (but with the added comfort that comes from using mathematical models).

Ever since coming up with my sea change thesis regarding interest rates two years ago, I've been talking about the increased utility of credit investments. And the more I've done so, the more I've thought about the difference between credit investments and equities. **Thus, the first thing I want to mention about my "Australian epiphany" is the unconventional idea that, at bottom, there are only two asset classes: ownership and debt.** If someone wants to participate financially in a business, the essential choice is between (a) owning part of it and (b) making a loan to it.

When I moved from Citibank's equity research department to its bond department in 1978, I learned firsthand that this is a matter of night and day. On my new desk, I found a machine called a Monroe 360/65 Bond Trader. If you typed in a bond's interest rate, maturity date, and market price, it would tell you the yield to maturity . . . in other words, what your return would be if you bought the bond at that price and held it to maturity (and it paid). **This was revolutionary to me. On the equity side I'd come from, there was no place you could look to find out what your return would be.**

This highlighted for me something I've always felt most investors don't grasp viscerally: the essential difference between stocks and bonds . . . that is, between ownership and lending. Investors seem to think of stocks and bonds as two things that fall under the same heading. But the difference is enormous. **In fact, ownership and lending have nothing in common:**

- Owners put their money at risk with no promise of a return. They acquire a piece of a business or other asset and **are entitled to their proportional share of any residual** that remains after the necessary payments have been made to employees, providers of raw materials, landlords, tax authorities, and, of course, lenders. If there's something left over, it's called profit or cash flow, and the owners have the right to share in whatever part of it is paid out. And if there's profit or cash flow (or the potential for it in the future), the business will have "enterprise value," in which the owners also share.
- Lenders typically provide funds to help owners purchase or operate businesses or other assets and, in exchange, are promised periodic interest and the repayment of principal at the end. **The relationship between borrower and lender is contractual,** and the resulting return is known in advance as described above, again assuming the borrower makes the promised payments when due. That's why this kind of investing is called "fixed income" – the income is fixed. For the purposes of this memo, however, it might help to think of it as "fixed outcome" investing.

This isn't a difference in degree; it's a difference in kind. Ownership assets (things like common stocks, whole companies, real estate, private equity, and real assets) and debt (bonds, loans, mortgage backed securities, and other streams of promised payments) should be thought of as entirely different, not variations on a theme. They have different characteristics and potential, and the choice between them is one of the most basic things investors must decide.

The Essential Choice

At the outset of this memo, I listed some of the decisions that comprise the asset allocation process. But how can those decisions be approached? What's the framework for making them?

The next piece that clicked into place in my thinking "down under" was with regard to the basic characteristics of a portfolio. **In my opinion, one decision matters more than – and should set the basis for – all the other decisions in the portfolio management process. It's the selection of a targeted "risk posture," or the desired balance between aggressiveness and defensiveness.** The essential decision in investing is how much emphasis one should put on preserving capital and how much on growing it. These two things are mostly mutually exclusive:

- Insistence on preserving capital – or, secondarily, on limiting the portfolio's volatility – calls for an emphasis on defense, which precludes pursuing maximum growth.
- Correspondingly, a decision to strive to maximize growth requires an emphasis on offense, meaning preservation of capital and steadiness must be sacrificed to some degree.

It's one or the other. You can't simultaneously emphasize both preservation of capital <u>and</u> maximization of growth, or defense <u>and</u> offense. <u>This is the fundamental, inescapable truth in investing.</u> The questions listed on page one are just details, the options available for reaching your targeted risk posture.

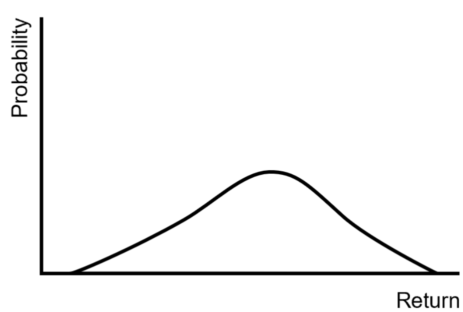
If you think about portfolio construction in this sense – looking for the right balance between offense and defense – it becomes clear that the goal should be optimization, not maximization. To my mind, it shouldn't be "wealth," but "wealth pursued in an appropriate way, taking into account the investor's wants and needs."

Many people think the proper goal in investing is achieving **the highest return**. More sophisticated thinkers understand – either intellectually or intuitively – that the goal should be to achieve **the best relationship between return and risk**. If you follow that latter mandate, it'll hopefully lead you to assets whose expected return is more than sufficient to compensate for their risk, and thus to a portfolio with the potential for an attractive risk-adjusted return. But that's not enough.

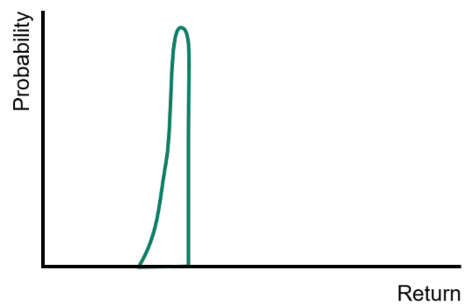
The absolute level of risk in a portfolio shouldn't be an unwitting consequence of the asset allocation process described above, or of the search for superior risk-adjusted returns. The absolute risk level must be consciously targeted. In fact, in my view, it's the most important thing. For an investment program to be successful, the level of risk in the portfolio must be well compensated <u>and</u> fall within the desired range . . . <u>neither too much nor too little</u>.

<u>The Shape of the Curves</u>

In the last few months, I've been drawing probability distributions to illustrate the fundamental difference between the potential returns from ownership assets and debt (or "fixed income," "credit," or whatever you want to call it). Here's the general shape of the curve describing the potential return on a portfolio of ownership assets (Figure 1):

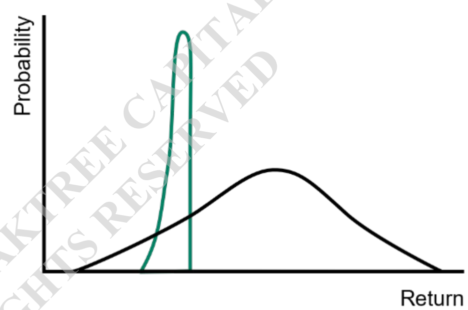


And following on page four is the shape of the curve describing the potential return on a portfolio of debt (Figure 2):

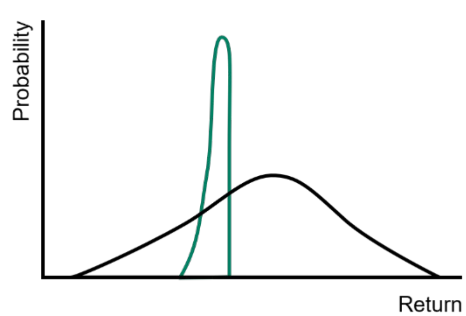


Ownership assets typically have a higher expected return, greater upside potential, and greater downside risk. Everything else being equal, the expected returns from debt are lower but likely to fall within a much tighter range. There's generally no upside on debt – no one should buy an 8% bond expecting to make more than 8% per year over the long term. But there's also relatively little downside – you'll get your 8% if the borrower pays, and relatively few fail to pay. For this reason, offense is usually better played through ownership assets, and defense is usually better played through debt. (I hasten to add that investing isn't a matter of either/or. The two can be combined, meaning the operative question surrounds the right mix.)

In the low-interest-rate environment that prevailed from 2009 through 2021, the expected return from debt was extremely low in the absolute and far below the historical return on equities, rendering debt relatively unattractive (Figure 3).



But today, it's considerably higher than it was and closer to that of equities (Figure 4). That's why I've been urging increased investment in credit.



Obviously, the relationship between the two curves at a point in time has a very direct bearing on the appropriate asset allocation at that time.

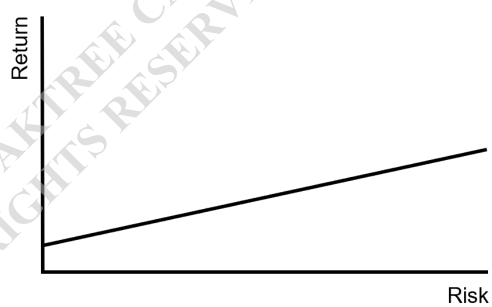
Which of the two is "better," ownership or debt? We can't say. In a market with any degree of efficiency – that is, rationality – it's just a tradeoff. A higher expected return with further upside potential, at the cost of greater uncertainty, volatility, and downside risk? Or a more dependable but lower expected return, entailing less upside and less downside? The choice between the two is subjective, largely a function of the investor's circumstances and attitude toward bearing risk. That means the answer will be different for different investors.

<u>Choosing the Offense/Defense Balance</u>

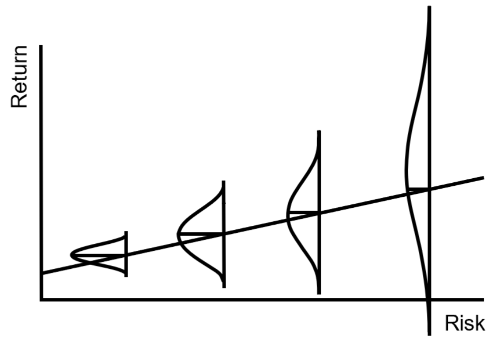
I've previously expressed my view that, as a starting point, every investor or their investment manager should identify their appropriate normal risk posture or offense/defense balance. For each individual or institution, this decision should be informed by the investor's investment horizon, financial condition, income, needs, aspirations, responsibilities, and, crucially, intestinal fortitude, or their ability to stomach ups and downs.

Once investors have specified the normal risk posture that's right for them, they face a choice: they can maintain that posture all the time, or they can opt to depart from it on occasion in response to the movements of the market and thus changes in the attractiveness of the offerings it provides, increasing their emphasis on offense when the market is beaten down and on defense when it's riding high.

Regardless of whether one's risk posture is fixed or variable, however, the next question is how one gets there. This question led me to think about another old idea: the relationship between risk and return. I've described a million times the way this was taught at the University of Chicago, beginning when I was there in the 1960s. It's a graphical presentation we've all seen ever since, in which, as we move from left to right, increasing the expected risk, the expected return also increases (Figure 5):

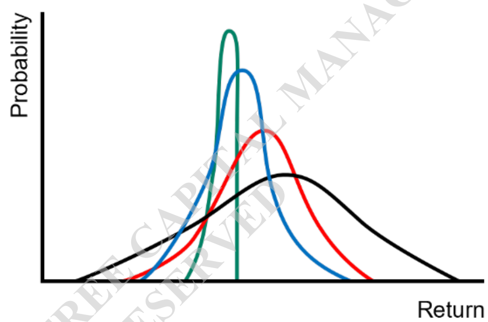


As readers know, I always felt this representation was highly inadequate, since **the linearity of the relationship in the graph makes it appear too certain that increased risk will lead to increased return. This obviously belies the nature of risk.** So, in a memo in 2006, I took the same line and superimposed on it some bell-shaped curves representing probability distributions turned on their side. I did this to indicate the uncertain nature of returns from riskier assets (Figure 6):



Now, we see that as the thing called "risk" increases (that is, as we move from left to right on the graph), not only does the expected return increase, but the range of possible outcomes becomes wider and the bad outcomes become worse. That's risk! (I hope this way of presenting risk will be considered a lasting contribution to the investment industry when I'm gone.)

Doodling one day, I took the black and green curves describing ownership asset returns and debt returns from Figure 4 and added some intermediate positions in blue and red to indicate various combinations of the two. Thus, the blue curve is 2/3 debt and 1/3 ownership, and the red is 1/3 debt and 2/3 ownership (Figure 7):



In Australia, as I was showing this diagram, it struck me that Figure 7 is just another way to represent the idea presented in Figure 6. Again, as we move from left to right (more ownership assets, less debt), the expected return increases and the expected risk increases (that is, just as in Figure 6, the range of possible outcomes grows wider and the left-hand tail stretches further into undesirable territory). This way of presenting the options might be more intuitively clear.

Someone who believes in "more risk, more return" as portrayed in Figure 5 should logically adopt a high-risk posture. But if they understand the real implications of increased risk, as suggested by Figures 6 and 7, then they might opt for something more moderate.

<u>The Role of Alpha and Beta</u>

All the foregoing assumes markets are efficient:

- As risk increases in an efficient market, expected return increases proportionally. Or maybe that's better stated the other way around: as expected return increases, so does the accompanying risk (the uncertainty surrounding the outcome and the likelihood of a bad one). Thus, no position on the risk continuum (for example, in Figure 6) is "better" than any other. It's all just a matter of where you want to come out in terms of absolute riskiness, or what absolute level of return you want to aim for. **The ratio of return to risk is similar at all points on the continuum** – less of both toward the left, and more of both toward the right. Said another way, there's no free lunch.

- Also, looking at each position on the risk continuum, **the symmetricalness of the vertical distribution of possible returns around the expected return is similar from one position to the next.** That means the ratio of upside potential to downside risk at one position on the continuum isn't markedly better than it is at other positions – again no free lunch.
- Finally, if you want to move further out on the risk continuum, you can do so by either (a) investing in riskier assets or (b) applying leverage to the same assets (magnifying both the expected return and risk). Again, in a fully efficient market, **neither tactic is preferable to the other.**

The above three statements capture some of the important implications of supposed market efficiency.

Looked at this way, the only thing that matters is getting to the right risk position <u>for you</u>; **under an assumption of market efficiency, there's nothing to be gained in terms of return at a given level of risk. All ways of getting to a certain risk level will produce the same expected return.**

The reason for this is the academic view that, in an efficient market, (a) all assets are priced fairly relative to each other, such that there are no bargains or over-pricings to take advantage of and (b) there's no such thing as alpha, which I define as "gains resulting from superior individual skill." **As a result, there's nothing to be gained from active decision making: no asset class, strategy, security or manager is "better" than any other. They merely vary in terms of risk and resulting return.**

Also in the academic view, since there's no such thing as alpha, the only thing that differentiates assets is their beta, or their relative volatility, the extent to which they reflect market movements. In the theory, it's beta that expected returns are proportional to.

Now it's time for me to assert strenuously that, **in reality, markets are <u>not</u> efficient in the academic sense of always being "right."** Markets may do an efficient job of (a) rapidly incorporating new information and (b) accurately reflecting the resulting consensus opinion concerning the right price for each asset given the totality of information, **but that opinion can be far from correct.** For that reason, gains <u>can</u> be achieved by choosing skillfully among the options:

- some assets, markets or strategies <u>can</u> offer a better risk/return bargain than others, and
- some managers <u>can</u> operate within a market or strategy to produce superior risk-adjusted returns.

This last idea raises one of the key questions in asset allocation: should you consider departing from your "sweet spot" in terms of risk level in order to invest in a riskier asset class with a manager believed to possess alpha? There's no easy answer to this question, especially given that many managers who are believed to possess alpha turn out not to.

To conclude, I'll recap the key points:

- Fundamentally speaking, the only asset classes are ownership and debt.
- They differ enormously in terms of their fundamental nature.
- Ownership assets and debt assets should be combined to get your portfolio to the position on the risk/return continuum that's right for you. This is the most important decision in portfolio management or asset allocation.
- The other decisions are merely a matter of implementation.

- Of course, your asset allocation process will be informed by how you rate your ability to identify and access superior strategies and superior managers, recognizing that doing so isn't easy.

*　　　*　　　*

Moving on to the real world, I want to make some important observations regarding one of Oaktree's key sectors, non-investment grade credit (defined as performing non-government debt):

- The prospective returns in this area today are much higher than they were in the 2009-21 period.
- These returns, starting at roughly 7% on public credit and 10% on private credit, are competitive with the historical returns on equities and capable of helping many investors toward their overall return targets.
- Because of their contractual nature, the returns from credit are likely to prove much more dependable than ownership returns.

In my view, the thought process set forth in this memo leads to the conclusion that investors should increase their allocations in this area if they are (a) attracted by returns of 7-10% or so, (b) desirous of limiting uncertainty and volatility, and (c) willing to forgo upside potential beyond today's yields to do so. For me, that should include a lot of investors, even if not everyone.

My recommendation at this time is that investors do the research required to increase their allocation to credit, establish a "program" for doing so, and take a partial step to implement it. While today's potential returns are attractive in the absolute, higher returns were available on credit a year or two ago, and we could see them again if markets come to be less ruled by optimism. I believe there will be such a time.

Thank you for indulging me in this foray into investment philosophy. I hope you've found it of value.

October 22, 2024

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Memo to: Oaktree Clients

From: Howard Marks

Re: On Bubble Watch

Exactly 25 years ago today, I published the first memo that brought a response from readers (after having written for almost ten years without receiving any). The memo was called *bubble.com*, and the subject was the irrational behavior I thought was taking place with respect to tech, internet, and e-commerce stocks. The memo had two things going for it: it was right, and it was right fast. One of the first great investment adages I learned in the early 1970s is that "being too far ahead of your time is indistinguishable from being wrong." In this case, however, I wasn't too far ahead.

This milestone anniversary gives me an occasion to write again about bubbles, a subject that's very much of interest today. Some of what I write here will be familiar to anyone who read my December memo about the macro picture. But that memo only went to Oaktree clients, so I'm going to recycle here the part of its content that relates to the subject of bubbles.

Since I'm a credit investor, having stopped analyzing stocks nearly five decades ago, and since I've never ventured far into the world of technology, I'm certainly not going to say much about today's hot companies and their stocks. All of my observations will be generalities, but I'm hopeful they'll be relevant nonetheless.

* * *

In this century's first decade, investors had the opportunity to participate in – and lose money due to – two spectacular bubbles. The first was the tech-media-telecom ("TMT") bubble of the late '90s, which began to burst in mid-2000, and the second was the housing bubble of the mid-aughts, which gave rise to (a) extending mortgages to sub-prime borrowers who couldn't or wouldn't document income or assets, (b) the structuring of those loans into levered, tranched mortgage-backed securities, and consequently (c) massive losses for investors in those securities, especially the financial institutions that had created them and retained some. As a result of those experiences, many people these days are on heightened alert for bubbles, and I'm often asked whether there's a bubble surrounding the Standard & Poor's 500 and the handful of stocks that have been leading it.

The seven top stocks in the S&P 500 – the so-called "Magnificent Seven" – are Apple, Microsoft, Alphabet (Google's parent), Amazon.com, Nvidia, Meta (owner of Facebook, WhatsApp, and Instagram), and Tesla. I'm sure I don't have to go into detail regarding the performance of these stocks; everyone's aware of the phenomenon. Suffice it to say that a small number of stocks have dominated the S&P 500 in recent years and have been responsible for a highly disproportionate share of its gains. A chart from Michael Cembalest, chief strategist at J.P. Morgan Asset Management, shows that:

- the market capitalization of the seven largest components of the S&P 500 represented 32-33% of the index's total capitalization at the end of October;
- that percentage is roughly double the leaders' share five years ago; and
- prior to the emergence of the "Magnificent Seven," the highest share for the top seven stocks in the last 28 years was roughly 22% in 2000, at the height of the TMT bubble.

It's also important to note that at the end of November, U.S. stocks represented over 70% of the MSCI World Index, the highest percentage since 1970 according to another Cembalest chart. Thus, it's clear that (a) U.S. companies are worth a lot compared to the companies in other regions and (b) the top seven U.S. stocks are worth a heightened amount relative to the rest of U.S. stocks. **But is it a bubble?**

What Is a Bubble?

Investment lingo comes and goes. My young Oaktree colleagues use a lot of terms these days for which I have to request translation. But "bubble" and "crash" have been in the financial lexicon for as long as I've been in the investment business, and I imagine they'll remain there for generations to come. Today, the mainstream media uses them broadly, and people seem to consider them to be subject to objective definition. **But for me, a bubble or crash is more a state of mind than a quantitative calculation.**

In my view, a bubble not only reflects a rapid rise in stock prices, but it is a temporary mania characterized by – or, perhaps better, resulting from – the following:

- highly irrational exuberance (to borrow a term from former Federal Reserve Chair Alan Greenspan),
- outright adoration of the subject companies or assets, and a belief that they can't miss,
- massive fear of being left behind if one fails to participate ("FOMO"), and
- resulting conviction that, for these stocks, "there's no price too high."

"No price too high" stands out to me in particular. When you can't imagine any flaws in the argument and are terrified that your officemate/golf partner/brother-in-law/competitor will own the asset in question and you won't, it's hard to conclude there's a price at which you shouldn't buy. (As Charles Kindleberger and Robert Aliber observed in the fifth edition of *Manias, Panics, and Crashes: A History of Financial Crises*, "there is nothing so disturbing to one's well-being and judgment as to see a friend get rich.")

So, to discern a bubble, you can look at valuation parameters, but I've long believed a psychological diagnosis is more effective. Whenever I hear "there's no price too high" or one of its variants – a more disciplined investor might say, "of course there's a price that's too high, but we're not there yet" – I consider it a sure sign that a bubble is brewing.

Roughly fifty years ago, an elder gave me the gift of one of my favorite maxims. I've written about it several times in my memos, but in my opinion, I can't do so often enough. It's "the three stages of the bull market":

> The first stage usually comes on the heels of a market decline or crash that has left most investors licking their wounds and highly dispirited. At this point, **only a few unusually insightful people are capable of imagining that there could be improvement ahead.**
>
> In the second stage, the economy, companies, and markets are doing well, and **most people accept that improvement is actually taking place.**
>
> In the third stage, after a period in which the economic news has been great, companies have reported soaring earnings, and stocks have appreciated wildly, **everyone concludes that things can only get better forever.**

The important inferences aren't with regard to economic or corporate events. They involve investor psychology. It's not a matter of what's happening in the macro world; it's how people view the developments. When few people think there can be improvement, security prices by definition don't incorporate much optimism. But when everyone believes things can only get better forever, it can be hard to find anything that's reasonably priced.

Bubbles are marked by bubble thinking. Perhaps for working purposes we should say that bubbles and crashes are times when extreme events cause people to lose their objectivity and view the world through highly skewed psychology – either too positive or too negative. Here's how Kindleberger put it in the first edition of *Manias, Panics, and Crashes*:

> . . . As firms or households see others making profits from speculative purchases and resales, they tend to follow. When the number of firms and households indulging in these practices grows larger, bringing in segments of the population that are normally aloof from such ventures, speculation for profit leads away from normal, rational behavior to what have been described as "manias" or "bubbles." **The word "mania" emphasizes the irrationality; "bubble" foreshadows the bursting.** (Emphasis added)

For me, it's psychological extremeness that marks a bubble. Often, as Kindleberger indicates, it can be inferred from widespread participation in the investment fad of the moment, especially among non-financial types. Legend has it that J.P. Morgan knew there was a problem when the person shining his shoes started giving him stock tips. My partner John Frank says he saw it in 2000, when he heard the dads at his son's soccer game bragging about the tech stocks they owned, and again in 2006, when a Las Vegas cab driver told him about the three condos he'd purchased. When Mark Twain purportedly said, "history doesn't repeat itself, but it often rhymes," it's this kind of thing he was talking about.

<u>The New, New Thing</u>

If bubble thinking is irrational, what is it that permits investors to get away from rational thinking, like the thrust of a rocket ship that breaks free of the limits imposed by gravity and attains escape velocity? There's a simple answer: **newness**. This phenomenon relies on another time-honored investment phrase, "this time is different."

Bubbles are invariably associated with new developments. There were bubbles in the Nifty Fifty stocks in the 1960s (more on them just below), disc drive companies in the 1980s, TMT/internet stocks in the late 1990s, and sub-prime mortgage-backed securities in 2004-06. These relatively recent manias followed in the tradition of ones like (a) the 1630s craze in Holland over recently introduced tulips and (b) the South Sea Bubble in 1720 England concerning the riches that were sure to ensue from a trading monopoly that the Crown had awarded to the South Sea Company.

In normal circumstances, if an industry's or a country's securities are attracting unusually high valuations, investment historians are able to point out that, in the past, those stocks had never sold at more than an x% premium over the average, or some similar metric. In this way**, attention to history can serve as a tether, keeping a favored group grounded on terra firma.**

But if something's new, meaning there is no history, then there's nothing to temper enthusiasm. After all, it's owned by the brightest people – the ones who are showing up in the headlines and on TV – and they've made a fortune. Who's willing to throw a wet blanket over that party or sit out that dance?

The explanation often lies in Hans Christian Andersen's story *The Emperor's New Clothes*. Con men sell the emperor an allegedly gorgeous suit of clothes that only intelligent people can see. But in actuality there is no suit. When the emperor parades around town naked, the citizens are afraid to say they don't see a suit, since that would mark them as unintelligent. This goes on unchecked until a young boy steps out of the crowd and – in his naivete – points out that the emperor has no clothes. Most people would rather go along with a shared delusion that's making investors buckets of money than say something to the contrary and appear to be dummies. **When a whole market or a group of securities is blasting off and a specious idea is making its adherents rich, few people will risk calling it out.**

<u>My Baptism Under Fire</u>

They say **experience is what you got when you didn't get what you wanted**, and I got my most formative experience at the very beginning of my career. As many of my memo readers know, I joined the equity research department at First National City Bank (now Citi) in September 1969. As was the case with most of the so-called "money-center banks," Citi invested mainly in the "Nifty Fifty"– the stocks of the best and fastest-growing companies in America. These companies were considered to be so good that (a) nothing bad could ever happen and (b) there was no price too high for their stocks . . . literally.

Three factors contributed to investors' fascination with these stocks. First, the U.S. economy grew strongly in the post-World War II period. Second, these companies benefitted from their involvement with areas of innovation such as computers, drugs, and consumer products. And third, they represented the first wave of "growth stocks," a new investment style that separately became a fad in itself. The Nifty Fifty were the object of the first big bubble in roughly 40 years, and since there hadn't been one for so long, investors had forgotten what a bubble looks like. As a result of the popularity that was conferred on them, if you bought these stocks on the day I started work and held them tenaciously for five years, you lost well over 90% of your money . . . in the best companies in America. What happened?

The Nifty Fifty had been put on a pedestal, and investors get hurt when something falls from it. The stock market as a whole declined by about half in 1973-74. And it turned out these stocks had been selling at prices that actually were too high; in many cases, their price/earnings ratios fell from the range of 60 to 90 to the range of 6 to 9 (that's the easy way to lose 90%). Further, bad things actually did happen to several of the companies in fundamental terms.

My early brush with a genuine bubble caused me to formulate some guiding principles that carried me through the next 50-odd years:

> **It's not what you buy, it's what you pay that counts.**
>
> **Good investing doesn't come from buying good things, but from buying things well.**
>
> **There's no asset so good that it can't become overpriced and thus dangerous, and there are few assets so bad that they can't get cheap enough to be a bargain.**

<u>Things Can Only Get Better</u>

The bubbles I've lived through have all involved innovations, as I noted above, and many of those were either overestimated or not fully understood. The attractions of a new product or way of doing business are usually obvious, but the potholes and pitfalls are often hidden and only discovered in trying times. A new company may completely outclass its predecessors, but investors who by definition lack experience in this new field often fail to grasp that even a bright newcomer can be supplanted. The disrupters can be disrupted, whether by skillful competitors or even newer technologies.

In my early decades in business, technology seemed to evolve gradually. Computers, drugs, and other innovative products improved a little at a time. But in the 1990s, innovation came in a big rush. When Oaktree was founded in 1995, I insisted that I could get by with just WordPerfect for word processing and Lotus 1-2-3 for spreadsheets. But when we moved to our current office in 1998, I threw in the towel and let our IT team install e-mail and the internet (and, of course, WordPerfect gave way to Word, and Lotus 1-2-3 to Excel). At the time, investors were sure "the internet will change the world." It certainly looked that way, and that assumption prompted tremendous demand for everything internet-related. E-commerce stocks went public at seemingly high prices and then tripled the first day. There was a real goldrush.

There's usually a grain of truth that underlies every mania and bubble. It just gets taken too far. It's clear that the internet absolutely did change the world – in fact, we can't imagine a world without it. But the vast majority of internet and e-commerce companies that soared in the late '90s bubble ended up worthless. When a bubble burst in my early investing days, *The Wall Street Journal* would run a box on the front page listing stocks that were down by 90%. In the aftermath of the TMT Bubble, they'd lost 99%.

When something is on the pedestal of popularity, the risk of a decline is high. When people assume – and price in – an expectation that things can only get better, the damage done by negative surprises is profound. When something is new, the competitors and disruptive technologies have yet to arrive. The merit may be there, but if it's overestimated it can be overpriced, only to evaporate when reality sets in. In the real world, trees don't grow to the sky.

The foregoing discussion centered on the risk of overestimating fundamental strength. But optimism surrounding the power and potential of the new thing often causes the error to be compounded through the assignment of too high a stock price.

- As mentioned above, for something new, there by definition is no historical indicator of what an appropriate valuation might be.
- Further, the companies' potential hasn't yet been turned into steady-state profits, meaning the thing that's being valued is conjectural. In the TMT Bubble, the companies didn't have earnings, so p/e ratios were out. And as startups, they often didn't have revenues to value. As a result, new metrics were invented, and trusting investors ended up paying a multiple of "clicks" or "eyeballs," regardless of whether these measurables could be turned into revenues and profits.
- Since bubble participants can't imagine there being any downside, they tend to award valuations that assume success.
- In fact, it's not infrequent for investors to treat all contenders in a new field as likely to succeed, whereas in reality only a few may thrive, or perhaps even survive.
- Ultimately, with a really hot new thing, investors can adopt what I call "a lottery ticket mentality." If a successful startup in a hot field can return 200x, it's mathematically worth investing in even if it's only 1% likely to succeed. And what doesn't have a 1% likelihood of success? When investors think this way, there are few limits on what they'll support or the prices they'll pay.

Obviously, investors can get caught up in the race to buy the new, new thing. That's where the bubble comes in.

What's the Appropriate Price to Pay for a Bright Future?

If there's a company for sale that will make $1 million next year and then shut down, how much would you pay for it? The right answer is a little less than $1 million, so that you'll have a positive return on your money.

But stocks are priced at "p/e multiples" – that is, multiples of next year's earnings. Why? Because presumably they won't earn profits for just one year; they'll go on making money for many more. When you buy a stock, you buy a share of the company's earnings every year into the future. The price of the S&P 500 has averaged roughly 16 times earnings in the post-World War II period. This is typically described as meaning "you're paying for 16 years of earnings." It's actually more than that, though, because the process of discounting makes $1 of profit in the future worth less than $1 today. The current value of a company is the discounted present value of its future earnings, so a p/e ratio of 16 means you're paying for more than 20 years of earnings (depending on the interest rate at which future earnings are discounted).

In bubbles, hot stocks sell for considerably more than 16 times earnings. Remember the 60 to 90 times for the Nifty Fifty! Investors in 1969 were paying for companies' earnings – even after giving them credit for significant earnings growth – many decades into the future. Did they do so consciously and analytically? Not that I recall. Investors thought of a p/e ratio as just a number . . . if they thought about it at all.

Today's S&P-leading companies are, in many ways, much better than the best companies of the past. They enjoy massive technological advantages. They have vast scale, dominant market shares, and thus above average profit margins. And since their products are based on ideas more than metal, the marginal cost of producing an additional unit is low, meaning their marginal profitability is unusually high.

The further good news is that today's leaders don't trade at the p/e ratios investors applied to the Nifty Fifty. Perhaps the sexiest of the seven is Nvidia, the leading designer of chips for artificial intelligence. It's current multiple of future earnings is in the low 30s, depending on which earnings estimate you believe. While double the average post-war p/e on the S&P 500, that's cheap compared to the Nifty Fifty. But what does a multiple in the 30s imply? First, that investors think Nvidia will be in business for decades to come. Second, that its profits will grow throughout those decades. And third, that it won't be supplanted by competitors. **In other words, investors are assuming Nvidia will demonstrate persistence.**

But persistence isn't easily achieved, especially in high-tech fields where new technologies can arise and new competitors can leapfrog incumbents. It's worth noting, for example, that only about half the Nifty Fifty (as enumerated by Wikipedia – there is no agreed-on list) are in the S&P 500 today (that figure undoubtedly looks worse than the reality, since mergers and acquisitions caused some of the old names to disappear, not failures). Leading lights of 1969 that are missing from the S&P 500 today include Xerox, Kodak, Polaroid, Avon, Burroughs, Digital Equipment, and my favorite, Simplicity Pattern (how many people make their own clothing these days?).

Another indication of how hard it is to persist can be seen in the names of the top twenty S&P 500 companies. At the beginning of 2000, according to finhacker.cz, these twenty companies were the most heavily represented in the index:

Microsoft	Merck
General Electric	Coca-Cola
Cisco Systems	Procter & Gamble
Walmart	AIG

Exxon Mobil
Intel
Citigroup
IBM
Oracle
Home Depot
Johnson & Johnson
Qualcomm
Bristol-Myers Squibb
Pfizer
AT&T
Verizon

At the beginning of 2024, however, only six of them were still in the top twenty:

Microsoft
Walmart
Exxon Mobil
Johnson & Johnson
Procter & Gamble
Home Depot

Importantly, of today's Magnificent Seven, only Microsoft was in the top twenty 24 years ago.

In bubbles, investors treat the leading companies – and pay for their stocks – as though the firms are sure to remain leaders for decades. Some do and some don't, but change seems to be more the rule than persistence.

<u>Whole Markets</u>

The greatest bubbles usually originate in connection with innovations, mostly technological or financial, and they initially affect a small group of stocks. But sometimes they extend to whole markets, as the fervor for a bubble group spreads to everything.

In the 1990s, the S&P 500 was borne aloft by (a) the continuing decline of interest rates from their inflation-fighting peak in the early 1980s and (b) the return of investor enthusiasm for stocks that had been lost in the traumatic '70s. Technological innovation and the rapid earnings growth of the high-tech companies added to the excitement. And an upswing in the popularity of stocks was reinforced by new academic research showing there had never been a long period in which the S&P 500 failed to outperform bonds, cash, and inflation. The combination of these positive factors caused the annual return on the index to average more than 20% for the decade. I've never seen another period like it.

I always say the riskiest thing in the world is the belief that there's no risk. **In a similar vein, heated buying spurred by the observation that stocks had never performed poorly for a long period caused stock prices to rise to a point from which they were destined to do just that.** In my view, that's George Soros's investment "reflexivity" at work. Stocks were tarred in the bursting of the TMT Bubble, and the S&P 500 declined in 2000, 2001, and 2002 for the first three-year decline since 1939, during the Great Depression. **As a consequence of this poor performance, investors deserted stocks en masse, causing the S&P 500 to have a cumulative return of <u>zero</u> for the more than eleven years from the bubble peak in mid-2000 until December 2011.**

Lately, I've been repeating a quote I attribute to Warren Buffett: "When investors forget that corporate profits grow about 7% per year they tend to get into trouble." What this means is that if corporate profits grow at 7% a year and stocks (which represent a share in corporate profits) appreciate at 20% a year for a while, eventually stocks will be so highly priced relative to their earnings that they'll be risky. (I recently asked Warren for a source on the quote, and he told me he never said it. But I think it's great, so I keep using it.)

The point is that when stocks rise too fast – out of proportion to the growth in the underlying companies' earnings – they're unlikely to keep on appreciating. Michael Cembalest has another chart that makes this point. It shows that prior to two years ago, there were only four times in the history of the S&P 500 when it returned 20% or more for two years in a row. In three of those four instances (a small sample, mind you), the index declined in the subsequent two-year period. (The exception was 1995-98, when the powerful TMT bubble caused the decline to be delayed until 2000. But then the index lost almost 40% in three years.)

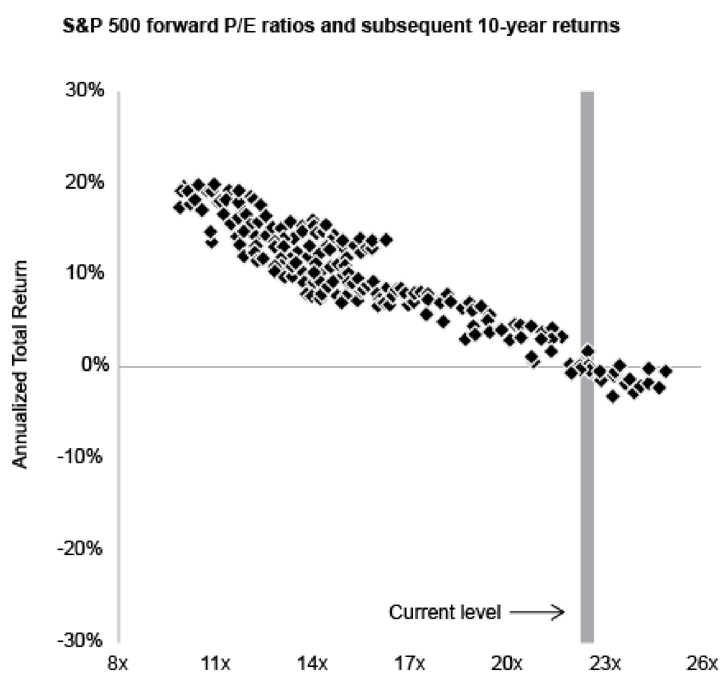
In the last two years, it's happened for the fifth time. The S&P 500 was up 26% in 2023 and 25% in 2024, for the best two-year stretch since 1997-98. That brings us to 2025. What lies ahead?

The cautionary signs today include these:

- the optimism that has prevailed in the markets since late 2022,
- the above average valuation on the S&P 500, and the fact that its stocks in most industrial groups sell at higher multiples than stocks in those industries in the rest of the world,
- the enthusiasm that is being applied to the new thing of AI, and perhaps the extension of that positive psychology to other high-tech areas,
- the implicit presumption that the top seven companies will continue to be successful, and
- the possibility that some of the appreciation of the S&P has stemmed from automated buying of these stocks by index investors, without regard for their intrinsic value.

Finally, while I'm at it, although it's not directly related to stocks, I have to mention Bitcoin. Regardless of its merit, the fact that its price rose 465% in the last two years doesn't suggest an overabundance of caution.

I often find that, just as I'm about to release a memo for publication, something comes along that demands inclusion, and it has happened again. On the last day of 2024, I received something from two sources that fits that description:



The graph, from J.P. Morgan Asset Management, has a square for each month from 1988 through late 2014, meaning there are just short of 324 monthly observations (27 years x 12). Each square shows the forward p/e ratio on the S&P 500 at the time and the annualized return over the subsequent ten years. The graph gives rise to some important observations:

- There's a strong relationship between starting valuations and subsequent annualized ten-year returns. **Higher starting valuations consistently lead to lower returns, and vice versa.** There are minor variations in the observations, but no serious exceptions.
- Today's p/e ratio is clearly well into the top decile of observations.
- In that 27-year period, when people bought the S&P at p/e ratios in line with today's multiple of 22, they always earned ten-year returns between plus 2% and minus 2%.

In November, a couple of leading banks came out with projected ten-year returns for the S&P 500 in the low- to mid-single digits. The above relationship is the reason. **It shouldn't come as a surprise that the return on an investment is significantly a function of the price paid for it. For that reason, investors clearly shouldn't be indifferent to today's market valuation.**

You might say, "making plus-or-minus-2% wouldn't be the worst thing in the world," and that's certainly true if stocks were to sit still for the next ten years as the companies' earnings rose, bringing the multiples back to earth. But another possibility is that the multiple correction is compressed into a year or two, implying a big decline in stock prices such as we saw in 1973-74 and 2000-02. The result in that case wouldn't be benign.

The above are the things to worry about. Here are the counterarguments:

- the p/e ratio on the S&P 500 is high but not insane,
- the Magnificent Seven are incredible companies, so their high p/e ratios could be warranted,
- I don't hear people saying, "there's no price too high;" and
- the markets, while high-priced and perhaps frothy, don't seem nutty to me.

*   *   *

As I said at the start of this memo, I'm not an equity investor, and I'm certainly no expert on technology. **Thus, I can't speak authoritatively about whether we're in a bubble. I just want to lay out the facts as I see them and suggest how you might think about them . . . just as I did 25 years ago.**

I hope you'll keep reading for the next 25!

January 2, 2025

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Memo to: Oaktree Clients

From: Howard Marks

Re: Gimme Credit

The questions I get from clients enable me to understand in real time what's on their minds. At various points in the last ten years, the most frequently asked question was "when will the Fed raise/cut rates?" During crises, it's usually "what inning are we in?" For a year or two, it's been "can we talk about private credit?" And in the last few months, it's "what about spreads?"

Ever since interest rates got up off the floor in 2022, there's been increased interest in credit, and that's why I'm devoting this memo to it. It'll come a little closer than usual to "talking my book," but I think the subject justifies that. Most of my references will be to high yield bonds, where I have the most experience, there's the most data, and the fixed coupon rates make the explanations most straightforward. But the points I'll make are applicable to credit in general.

While I'm setting the stage, I want to get one thing out of the way. **When people ask me, "can we talk about private credit?" my answer is always the same: "can we talk about credit?"** I see no reason why investors should blithely skip over public credit instruments and go straight to private credit. For that reason, I'm going to address both here.

Last year was a great one for credit, illustrated by the 8.2% return on the ICE BofA US High Yield Bond Index. That followed even better results in 2023, when the benchmark returned 13.5%. What's been behind these returns, and where do they leave the credit sector?

<u>Background</u>

As everyone knows, promised yields on credit instruments were meager in the low-interest-rate period I've discussed so much: 2009-21. At the beginning of 2022, before the Fed embarked on its program of interest rate hikes, high yield bonds yielded in the 4% range, with issuance taking place in the 3s and one bond issued in the 2s! I described Oaktree's challenge at that time as "investing in a low-return world." The ultra-low bond yields were unhelpful for most institutional investors, and many got out of the habit of investing in fixed income. There was, however, good interest in private credit, where yields in the area of 6% were being levered up to 9% or so.

In 2022, investors who feared the Fed's rate increases would bring on a recession caused the average high yield bond price to incorporate risk protection in the form of a yield spread of more than 4%, taking the overall yield to roughly 9½%. I argued at the time that these promised returns were (a) high in the absolute, (b) relatively safe because of their contractual nature, and (c) well in excess of the returns most institutions targeted. For these reasons, I urged that credit should be weighted significantly in portfolios.

These high-single-digit yields alone would have given holders healthy returns. However, investors began to buy because they saw there was good value in credit, and they anticipated rate cuts that would make bonds with high coupons more desirable. Over time, investors also became less worried about a possible recession, and this led to reduced insistence on generous risk protection via credit spreads. Increased demand, lower interest rates, and reduced insistence on risk protection in the form of higher spreads is a perfect formula for price appreciation, and it ensued. This caused the bonds' total returns to exceed the promised yields, and as a result, the high yield bond market delivered an annualized return of 10.8% over the two-year period 2023-24.

The flip side of a rising price, of course, is a declining prospective return. As a result of the developments described above, the yield to maturity on the average high yield bond now stands just above 7%, down from 9½%. Just as rising fear and risk aversion cause investments to offer higher prospective returns, rising optimism and risk tolerance lead to lower ones, incorporating reduced yield spreads. (The reduced yield is also attributable to 100 basis points of cuts in the base interest rate.)

What Is a Yield Spread?

Why would someone lend money to a risky borrower when there are plenty of safe borrowers to lend to? The answer is that risky borrowers pay more for their money, and if you can charge a risky borrower an interest rate that's high enough to produce a return above that available on safe debt, even after allowing for expected credit losses, it could be worth taking the risk. That was precisely the theory that underpinned Michael Milken's popularization of high yield bonds in the late '70s, as well as my career.

The differential between the promised yield on risky debt and the yield on a less risky comparator is called a "yield spread," "credit spread," or just plain "spread." It's also called a "risk premium," which is what it is: the incremental return you're offered to accept incremental default risk. Thus, it's the equivalent of an insurance premium: what policyholders pay to get auto insurers to shoulder the risk that they'll crash their cars.

Yield spreads primarily fluctuate with trends in, and investor psychology regarding, defaults. When more companies are defaulting and investors expect elevated defaults in the future, they'll demand more protection in the form of wider spreads. They'll do so to a lesser degree when they're optimistic about creditworthiness. Thus, the spread is a good barometer of investor psychology, or a "fear gauge." It's worth noting the obvious: the spread doesn't tell you what the actual default rate will be, as some mistakenly say. It tells you what investors think the default rate will be. The thoughtful investor has to evaluate that expression of opinion against what the reality is likely to be and assess whether investors are being too optimistic or too pessimistic.

Are Today's Yield Spreads Adequate?

This is the question of the day. Let's say high yield bonds yield 8% and a Treasury note of the same maturity offers 5%, for a yield spread of 3%, or 300 basis points. Which is the better deal? It all depends on the likelihood of default. If high yield bonds have a 4% chance of defaulting each year and you're likely to lose three-quarters of your money in a default, your expected annual credit loss is 3% (4% x 75%). If those estimates are accurate, you should be indifferent between the two. Or (holding constant the 75% loss in case of default), you should prefer the Treasury note if high yield bonds are more than 4% likely to default or high yield bonds if they're less than 4% likely to default.

When I managed high yield bonds, I considered the normal range for spreads to be 350-550 basis points. More recently, I think this has been revised to 400-600 bps. Today, however, the yield spread is around 290 bps, one of the narrowest spreads on record since high yield bonds began to be issued in 1977-78. Does that mean investors shouldn't hold them here? That's what people mean when they ask me, "can we talk about spreads?"

It's essential to note that the "normal" spreads mentioned above have proved far more than adequate. We know this because the unmanaged high yield bond indices – even with their defaults and credit losses – have significantly outperformed no-risk Treasurys. Data from Barclays shows that from 1986 through 2024, the 39-year period covered by Oaktree's record, the annualized return on high yield bonds was 7.83%, compared to 5.14% on 10-year Treasurys. **The fact that the average high yield bond gave investors 269 bps more return per year than Treasurys tells us the historical spread was considerably more than sufficient to offset credit losses. Thus, the historical spread shouldn't necessarily be the standard for adequacy, and investors might intelligently opt for high yield bonds over Treasurys even at spreads below the historical average.**

Thus, the key question isn't whether today's spread is historically narrow or not. It's whether today's spread is sufficient to offset the credit losses that will occur. This takes us back to the calculation discussed three paragraphs above. Over the course of Oaktree's 39-year track record in high yield bonds, from 1986 through 2024, the high yield bond universe's default rate has averaged 3.5%, and defaulting bonds have cost investors about 2/3 of the money they had at stake, meaning annual credit losses have amounted to about 230 bps (two-thirds of 3.5%). This suggests today's historically narrow spread of about 290 bps would have been enough to offset the defaults that occurred in the past. Before that's accepted as the appropriate conclusion on the subject, however, there are caveats to be considered:

- **The average default rate of 3.5% overstates the typical experience.** That 3.5% average is far from the norm. Out of the 39 years covered by Oaktree's track record, there were only 14 years when the universe's default rate was at or above 3.5%, and 25 when it was below. The average was pulled up by double-digit default rates during crises in 1990-91 and 2001-02. If you took out those four years (along with the four best years, in which defaults were 1.0% or less), the average for the remaining 31 years was just 3.0%. Further, the median default rate for the 39 years (the midpoint of the annual observations) was even lower, at 2.7%.

- **The historical default rate might not be relevant to the future.** In the Global Financial Crisis of 2008-09 and the Covid-19 pandemic of 2020, central banks and national treasuries showed that they've developed tools with which to counter recessions and credit crunches. As a result, the default experiences associated with those events were well below those in the earlier crises, even though the GFC and pandemic were much more serious in a macro sense. **Thus, it can be argued that the macro environment has become safer, meaning the historical spreads are no longer called for.**

- **The average high yield bond's credit rating (supposedly an indicator of quality) has risen substantially.** Mainly because companies are less concerned about ratings these days, large numbers of investment grade triple-B-rated companies have opted to increase their use of leverage and allow their rating to slip to double-B, the upper tier of the high yield bond universe. The following table shows the change in the ratings profile of the high yield bond universe over the last 25 years:

	<u>December 31, 1999</u>	<u>December 31, 2024</u>
BB	32.7%	52.6%
B	54.6	33.7
CCC and below	12.7	13.7

Data from ICE

Research from Barclays indicates that since the average high yield bond is now higher in creditworthiness, today's average yield spread provides a good bit more compensation per unit of credit risk today than it did at the "all-time tight" of 2007.

- Active credit managers strive to reduce (a) the incidence of default in their portfolios and (b) the percentage of capital lost when defaults occur. Since the historical spreads have been adequate to protect against average credit losses in the past, that means they've proved more than adequate for investors with superior credit discernment. **For high yield bond managers with the ability to reduce credit losses through active management, there's a greater likelihood that spreads will prove sufficient to offset future credit losses.**

For all these reasons plus one more, I believe the concern about historically narrow spreads is very much overblown. **My additional point is that spread widening is a short-term phenomenon, analogous to volatility in stocks.** If the yield spread widens, increasing the demanded yield, that results in a price decline for bondholders. But the price decline is temporary, whereas the higher interest payments are received every year . . . and then the bond eventually returns to par at maturity (assuming it performs).

I did some research with Oaktree's Nicole Adrien to test this thesis. We identified the all-time lowest yield spread on our usual high yield bond benchmark and looked to see how we would've fared if we'd bought bonds that day. The lowest spread was 241 bps, reached in June 2007, just prior to the onset of the Global Financial Crisis. Here are the results for high yield bonds and some comparative indices if you chose that time to invest:

Annualized Returns Following All-Time Tight U.S. High Yield Bond Spread

	ICE BofA U.S. High Yield Index	ICE BofA U.S. Treasury Index	Bloomberg U.S. Aggregate Index
1 year	-1.13%	10.19%	7.54%
3 years	5.29	7.27	6.99
5 years	7.26	7.20	6.83
10 years	7.35	4.15	4.47
15 years	6.01	3.03	3.34

Source: ICE, Bloomberg
Note: BofA U.S. High Yield Index all-time tight gov't OAS spread (241 bps) recorded on June 1, 2007

The one-year return on high yield bonds shows, unsurprisingly, that if you buy a risky asset at the height of its popularity and immediately encounter one of the worst financial crises the world has seen, your initial experience won't be good. Thus, in the first year following the purchase at the low on spreads, high yield bonds underperformed Treasurys by 11.3 percentage points and the U.S. Aggregate Bond Index by 8.7 percentage points. **But note that the high yield bond investor still lost very little money, thanks to the receipt of interest!** (At Oaktree, we call this "the power of the coupon.")

High yield bonds didn't pull ahead of Treasurys and the Aggregate until the five-year mark, but over the 10- and 15-year periods, they outperformed those indices by about 3 percentage points per year despite having been bought at the worst possible moment spread-wise. Of course, managers able to navigate defaults in the high yield universe would have achieved even better returns. **As the above data shows, narrow spreads at purchase are far from synonymous with sub-par performance in the medium-to-long term.**

The bottom line for me – as I tell anyone who asks – is that you can't eat spread, or spend spread, or pay pension benefits with spread. For those things, you need returns. Spreads have to be assessed to ensure they'll be adequate to offset credit losses, but in the end, it's the total return that matters.

Contractual Returns

A good part of the reason for the ability of high yield bonds to perform even when spreads have been historically tight, as shown above – and for investors' ability to ignore the spread tightening that has taken place to date, as I argue – stems from the contractual nature of bond returns. You buy a bond at a given yield to maturity, which could incorporate an anemic yield spread. And if investors decide later to demand increased default protection, the spread will widen and – all else being equal – the price of the bond will decline. **But as long as the issuer pays interest and principal as promised, the price decline brought on by spread widening has only a temporary effect. When you're repaid at par, you'll have received the yield you expected, regardless of price fluctuations experienced in the meantime, including declines related to spread widening.** The bottom line is one that applies to all bonds: if you hold to maturity and the bonds pay, you receive the yield you signed up for. I've written so much about this that I'm not going to belabor it further (see my memo *Ruminating on Asset Allocation*, October 2024), but I'm always available to talk.

(Before the bond pros jump down my throat, I'll admit that the foregoing is less than 100% accurate. There are three components in bond returns, not two. Everyone knows about the interest payments and the movement of price to par at maturity. But there's a third: the interest earned from reinvesting the annual interest payments, better known as "interest on interest," and thanks to the power of long-term compounding, this is a major matter on 20- or 30-year bonds. The standard yield-to-maturity calculation assumes interest receipts are reinvested at the yield in effect at time the calculation is performed (for example, at purchase), but that's a simplifying assumption, and the reality may well be different. No one wants to see the price of a bond one owns decline. But the truth is that if the bond price declines, the yield rises, meaning interest payments received can be reinvested at a higher rate than was anticipated. **Thus, surprisingly, interim price declines can raise the overall return earned from holding a bond to maturity.**)

What About Private Credit?

This is today's other FAQ, along with the one about spreads. A lot of people have questions about private credit, which makes one wonder how the sector can be seeing such strong capital inflows. My responses generally go like this:

- **Like anything else, there are pros and cons.** The most obvious pro is that, to compensate for the lack of liquidity, private credit offers higher yields than public credit. The second is that private credit managers are able to offer funds (and thus returns) that are levered, which isn't true of most public credit funds. The main negative stems from the absence of a market for the loans, and thus their illiquidity and the difficulty of actively managing holdings. Further, because there's no market, private credit can't actually mark to market. A final negative is that the fees are higher on private credit investing than on public credit, often including an incentive fee.

- **What about the lack of marking to market, and the resulting low level of volatility?** It's obviously unrealistic to think the value of private loans doesn't fluctuate. But on the other hand, it seems many people consider the non-marking to market a plus, in that they can report that their investments didn't go down much in a difficult environment. Private credit managers are supposed to mark their holdings to reality based on fundamentals, but that's clearly less volatile (and less objective) than marking to a market. On the other hand, is it desirable that public asset prices reflect every up and down of investor psychology? **Not marking to market may be unrealistic, but it may be welcome.** (Investors in public securities could have the same experience if they refused to read the newspapers and tossed their brokerage statements in the drawer, but such behavior would be called irresponsible.)

- For me, the most important observation about private credit is that it mostly emerged since 2011 in response to banks' reduced lending activity after the Global Financial Crisis. Since then, the economy has witnessed an unusually long string of years without a recession (if you don't count the two-month Covid 19-related recession that flared up and was reversed in mid-2020). **To paraphrase Warren Buffett, the tide has never gone out on private credit**, meaning we haven't had an opportunity to see its flaws. As far as I'm concerned, the main one is the possibility that some managers have been in such a hurry to scoop up capital and put it to work – so they could come back for more – that they relaxed their credit standards and failed to demand a sufficient margin of safety. If there's ever another difficult period in the economy and the market, we'll see the result. Note: this isn't a sweeping concern about the loans themselves, just a question about the behavior of individual managers.

- Connected to the above (and to the absence of marking to market), **we don't know what'll happen if and when a difficult environment does arrive**. Is there a limit on the ability of managers to keep marks too high? Is it right for fund returns to ignore deteriorated fundamentals? Can managers avoid recognizing credit difficulties by granting forbearances and "kicking the can down the road"? For how long? Are there ill effects on fund investors in the meantime? Since private credit managers are mostly unregulated, will the truth come out? Which truth? Questions like these also are answered only when the tide goes out.

- **Lastly, I don't believe private credit represents a systemic risk.** People have been on the lookout for systemic risk ever since the GFC, in which troubled banks brought trouble to other banks and took them down. My belief is that the risk in private credit isn't systemic, since (a) private loan portfolios and their owners aren't levered nearly as much as banks were in 2007-08 and (b) there isn't the same level of interconnectedness, or "counterparty risk," since the holders haven't sold each other default protection and other forms of hedging, like banks did before the GFC. There are those who believe some holders of private credit have multiple layers of leverage, which could increase the risk in a downside scenario, but I have no way of knowing.

The bottom line for me is that the return premium on private credit relative to public credit seems roughly fair given the merits. Extra return is a good thing, but the downside related to the lack of liquidity and resulting difficulty in actively managing holdings is a real consideration. All else equal, I would suggest employing a combination of the two.

Credit Versus Equities

I've written about equity valuations – primarily referencing the Standard & Poor's 500 – as recently as this January in my memo *On Bubble Watch*. Suffice it to say that, according to past data, from p/e ratios like today's, the S&P has historically produced ten-year returns averaging between -2% and 2% per year, and some investment banks have expressed expectations that are similarly in the low to mid-single digits. Obviously, today's expected returns on credit are considerably higher.

On January 27, an article on the front page of *The Wall Street Journal* said the following: "Stocks haven't looked this unattractive, by at least one measure, since the aftermath of the dot-com era." This wasn't a reference to the elevated p/e ratio, but to the fact that the yield on the 10-year U.S. Treasury note is higher than the "earnings yield" on the S&P 500 stock index. (The earnings yield is the ratio of earnings to price, the inverse of the p/e ratio.) This doesn't prove that bonds are going to beat stocks in the years ahead, but it's one more argument. And if Treasurys are poised to out-yield the S&P 500, high yield bonds will do so to an even greater extent (assuming credit losses don't exceed the historical experience).

As I've written in other memos recently, **the current level of offered yields implies higher returns from credit than the S&P 500, with returns that are contractual and thus subject to much less variability and uncertainty**. This is true despite the return contraction that has been brought on by the swing from pessimism to optimism over the last two years, and even given today's narrow spreads.

* * *

The bottom line is that credit presently offers a better deal than equities (to the extent the S&P 500 is representative of equities), even at today's spreads. **Credit isn't a giveaway today, but it offers healthy absolute returns and is fairly priced in relative terms. This is true despite the narrowness of yield spreads.** These observations aren't limited to high yield bonds. They also apply to senior loans, mezzanine debt, asset-backed loans, CLOs, and private lending.

We'd rather buy at higher yields and wider spreads, and we may get a chance to do so . . . or not. But that preference in itself isn't a reason for not increasing allocations to credit today.

March 6, 2025

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Memo to: Oaktree Clients

From: Howard Marks

Re: Nobody Knows (Yet Again)

On Monday, September 15, 2008, shortly after the close of the New York Stock Exchange, Lehman Brothers surprised the world by filing for bankruptcy. This came on the heels of rescues/bankruptcies of Bear Stearns and Merrill Lynch and was followed quite soon by more of the same at Wachovia, Washington Mutual, and AIG. Market participants quickly concluded that the U.S. financial sector was likely to melt down. It was now patently obvious (unlike a few days earlier) that financial institutions might fall like dominoes due to the combination of (a) financial deregulation, (b) a manic housing boom, (c) unwise mortgage lending, (d) the structuring of mortgages into thousands of tranched securities that were rated too high, (e) investment in these securities on the part of highly levered banks, and (f) "counterparty risk" resulting from the banks' interconnectedness. This thesis couldn't be refuted, and as a result, the markets embarked on what felt like a downward spiral without end.

I thought I should comment on these developments and the outlook, and the result was a memo called *Nobody Knows*, published four days later. I affirmed my ignorance of the future as usual, but to an even greater degree given that all prior expectations had been upended. Nobody knew – especially me – whether the spiral could be arrested. Nevertheless, I concluded that we had to assume it would, and thus that we should plow money into financial assets at their highly discounted prices.

There was nothing anyone could say they "knew," and that included me. I was limited to gaming out my conclusions, which were as follows:

- we can't confidently predict the end of the world,
- we'd have no idea what to do if we knew the world would end,
- the things we'd do to gird for the end of the world would be disastrous if it didn't end, and
- most of the time the world doesn't end.

Clearly, I didn't base these conclusions on knowledge of the future. But I saw no logical choice other than to start putting money to work, including the $10 billion that was sitting uninvested in Opportunities Fund VIIb. We had formed that fund to prepare for an elevated opportunity in distressed debt. How could we not follow through when one arrived? **And yet, we admittedly had no idea what the future would bring.**

I can't claim to have analyzed the future. In fact, I consider the phrase "analyze the future" one of the great oxymorons. The future has not yet been created, and it's subject to millions of complex, unquantifiable, and unknowable factors that will always be in flux. You can ponder the future and speculate about it, but there's nothing to "analyze" and certainly there wasn't in the early days of the Global Financial Crisis.

In March 2020, I reused the title of the 2008 memo for *Nobody Knows II*, my first memo during the Covid-19 pandemic. In it, I cited Harvard epidemiologist Marc Lipsitch, who said we usually make decisions on the basis of (a) facts, (b) informed extrapolations from analogous experiences, and (c) opinion or speculation. But since there were no applicable facts regarding a Covid pandemic and no analogous experiences, we were left with only speculation.

I want to say right here about 2008 and the other crises I've invested through – as well as today – that I don't reach my conclusions with confidence or act without trepidation. There's absolutely no place for certainty in the world of investing, and that's particularly true at turning points and during upheavals. I'm never sure my answers are right, but if I can reason out what's most logical, I feel I have to move in that direction.

The Uncertain Outlook

In my February memo *2024 in Review*, which went only to clients, I said the word to describe the Trump administration was "uncertainty." President Trump's thinking seems less predictable than that of most presidents, largely because it doesn't necessarily hew to a consistent ideology, and it's very much subject to being applied and revised tactically. It should be noted, however, that Trump has complained about how the U.S. is treated in world trade and argued in support of tariffs since at least 1987. Having said that, and even though we knew he was going to hike tariffs, no one anticipated the magnitude of the increases. Clearly the markets hadn't.

Last week's events remind us of the events of 2008 and the Global Financial Crisis they produced. All norms have been overthrown. The way world trade has operated for the last 80 years may be of little relevance to the future. The impact on economies and the world at large is entirely unpredictable. We're faced with large-scale decisions, yet again there are no facts or prior experiences on which to base those decisions. Truly nobody knows, and a lot of this memo will be about things we can't know for sure. But I hope it'll help you organize and evaluate the issues.

I want to point out that there are no experts on the subject at hand. Economists have analytical tools and theories to apply, but no economist and no tool will produce a conclusion in this instance that we can follow with confidence. There have been no large-scale trade wars in the modern era; thus, the theories are untested. Investors, businesspeople, academics, and government leaders will all give advice, but none of them is much more likely to be right than the average intelligent observer. The things on which everyone will agree are obvious, like the likelihood of higher prices. The less obvious truths will be harder to discern.

One of the things I insist on is that even for someone who deals with the future via forecasts, a forecast isn't enough. **In addition to a forecast, you have to have a good sense for the probability your forecast is correct. In this case, under these circumstances, it must be accepted that forecasts are even less likely to prove correct than usual.**

Why? Primarily because of the vast number of unprecedented unknowns involved in the current matter, which has the potential to turn into the biggest economic development in our lifetimes. There's no such thing as foreknowledge here, just complexity and uncertainty, and we must accept that as true. **This means that if we insist on achieving certainty or even confidence as a precondition for action, we'll be frozen into inaction. Or, I dare say, if we conclude we've reached decisions with certainty or confidence, we'll probably be mistaken. We must make our decisions in the absence of those things.**

But we also have to bear in mind that deciding not to act isn't the opposite of acting; it's an act in itself. The decision to not act – to leave a portfolio unchanged – should be scrutinized as critically as a decision to make changes. The old saws that are the refuge of terrified investors – "we're not going to try to catch a falling knife" and "we should wait for the dust to settle and the uncertainty to be resolved" – cannot in themselves be allowed to determine our behavior. **I love the title of a book by a market**

analyst named Walter Deemer: "When the Time Comes to Buy, You Won't Want To." The negative developments that make for the greatest price declines are terrifying, and they discourage buying. But, when unfavorable developments are raining down, that's the optimal time to step up.

Lastly, given Trump's tactical focus, it's important to bear in mind that absolutely everything is subject to change. It shouldn't surprise anyone if he extracts concessions and declares victory . . . or if he responds to other countries' retaliation by escalating further. Thus, I told a Wharton conference on Friday that if anyone thinks they know what a given tariff rate will be three months from now, I'll bet good money they're wrong – even without knowing what they think the answer is.

<u>Tariffs</u>

What are President Trump's reasons for enacting his tariffs, and are they valid? On the day of the announcement, I heard a TV commentator credit Trump's "impulses" as having some justification. What are his goals? They include some or all of the following:

- support U.S. manufacturing
- encourage exports
- discourage imports
- shrink or eliminate our trade deficit
- make supply chains more secure through onshoring
- deter unfair trade practices aimed at the U.S.
- force other countries to the negotiating table
- generate revenue for the U.S. Treasury

It must be acknowledged that every one of these things is desirable in itself and a logical result of tariffs.

If only it were that easy. **The problem is that in the real world, and especially in economics, there are second- and third-order consequences that must be considered.** If there weren't, economics would be dependable like the physical sciences, as in "if you do A, then B happens." As theoretical physicist Richard Feynman said, "imagine how much harder physics would be if electrons had feelings." Well, economies and markets are made up almost entirely of people, and people do have feelings, rendering reactions unpredictable. In economics, others will react to action A, as well as to result B that action A produces, and we have to think about the effect of those reactions. Not only are repercussions often significant, but they're also unpredictable. Further, politics plays a particularly significant and unpredictable role in the matter at hand, with a calculus all its own.

What are some of the likely consequences of Trump's tariffs? The list is long, and many are particularly serious:

- retaliation by other countries
- price increases and rising inflation
- destruction of demand due to price increases and declining consumer confidence
- recession and lost jobs, both in the U.S. and around the world
- supply shortages
- a massive change in the world order

There are many threads to follow, and if I try to do them all justice, we'll be here forever. I'll just touch on a few.

Some countries will negotiate – after all, in most cases, to borrow Trump's terminology, the U.S. is "holding the best cards." But others won't, perhaps because their leaders will insist on looking strong, leading to escalation. Higher "reciprocal tariffs" are unlikely to accomplish anything positive on balance and will probably make life worse for both parties. It will be of scant satisfaction if the incremental problems we encounter are less bad than those befalling other nations.

There is little doubt that the tariffs will raise prices. Tariffs are taxes on imports, and someone has to pay them. This is true in the case of goods brought in from abroad, as well as goods made in the U.S. that incorporate imported materials or components. This means the effect will be widespread. While it's the importer who pays the tariff at the border, the cost is usually passed on to the ultimate purchaser of the goods, the consumer. In theory, the manufacturer, exporter, exporting country, or importer can choose to absorb the tax to preserve their business, but they won't be eager to cut into their profits to do so, and in many cases their profit margins aren't high enough to allow them to do so.

Note that in my March 2022 memo, *The Pendulum in International Affairs*, I observed that between 1995 and 2020, U.S. consumer durable prices declined by 40% in real terms and total inflation averaged only 1.8% per year. Consumer durables consist mostly of vehicles, appliances, and electronics, and a big percentage of these have been imported. **What would inflation have been if low-cost imports were discouraged or precluded?**

But let's assume the first three goals listed above are actually achieved, causing more of the goods purchased in the U.S. to be made in the U.S.:

- First, in most cases, there isn't sufficient manufacturing capacity that can be switched on. For example, I doubt there's a factory in the U.S. capable of producing flat screens for TVs or computers. It would take years to build enough capacity to satisfy a meaningful percentage of U.S. demand, meaning in the interim there would be shortages and/or selling prices would likely be at the old levels plus the tariffs.
- Second, the new factories designed to bring back manufacturing jobs would take years to permit and build, and the cost of construction would have to be justified by an expectation of profits many years out in the future. Are CEOs likely to commit to those investments based on tariffs that might be subject to renegotiation (or discontinuation when a new administration takes office)? Bear in mind that Trump's 25% tariff on Mexican and Canadian goods replaced the United States-Mexico-Canada Agreement he negotiated during his first term and that went into effect in 2020, which in turn replaced NAFTA, which was enacted in 1994.
- Third, there probably aren't enough skilled workers available in the U.S. to take the place of all those in China and the developing world who presently make goods for us.
- **Fourth, why have Americans been buying imports in the first place? Because they're cheaper.** Why did the U.S. lose the jobs it lost? Because American workers were paid more than workers elsewhere for the same job, but U.S. products weren't good enough to justify higher selling prices. That's why the U.S. went from importing 330 Volkswagens in 1950 to more than 400,000 in 2012. It wasn't that U.S. tariffs were too low. The simple truth is that foreign goods often cost less than comparable goods made in the U.S.

Even if tariffs are set high enough in the future to render U.S.-made goods cheaper than imports-cum-tariffs, the price of the goods will be higher in the absolute than those of a week ago. **Prices are virtually certain to be higher for U.S.-made goods than those of the imports Americans have been buying.**

Since most Americans have little income left over after paying for necessities, the result of higher prices is likely to be declining standards of living. That's true unless wages rise as fast as prices, but in that unlikely case we're talking about a dangerous inflationary spiral.

Higher prices are likely to result in lower unit sales, and thus in declining profit margins. My favorite economist (there's an oxymoron for you), Conrad DeQuadros of Brean Capital, considers corporate profit margins to be the best leading indicator of recessions. When margins come under pressure, corporations engage in layoffs and other forms of cost-cutting, often leading to economic downturns.

And again, there's the complexity of economic cause and effect. It's widely reported these days (I have no idea how reliably) that when tariffs were imposed on imported steel in 2018, 1,000 jobs were saved in the U.S. steel industry. But 75,000 jobs were lost (or potential new employees weren't hired) in U.S. steel-using industries. Similarly, as I wrote in the memo *Economic Reality* in May 2016:

> How will the interests of the 3.2 million Americans estimated to have lost their manufacturing jobs to China be balanced against the hundreds of millions who would have to pay considerably more for imported goods? Not an easy question.

Economics is the science of choices and is fraught with trade-offs. That's certainly true in the area of trade and tariffs.

The International Picture

The impact of the developments on tariffs extends importantly to the international arena and goes well beyond economics. Global trade has had an enormous beneficial effect on the entire world since the end of World War II. Along with expenditures to rebuild after the war, technological and managerial progress, improvements in infrastructure, and the expansion of capital markets, **globalization contributed to a rising economic tide that truly lifted all boats**. Some countries and some people did better than others, of course, but virtually everyone was better off. I believe it was because of this, among other things, that we've generally enjoyed peace and prosperity for the last 80 years. **As a result, we've been privileged to live in the best period in history.**

The main benefit from globalization is called "comparative advantage." Every country has some things it produces better and/or cheaper, and others where the reverse is true. If every country makes the former products and sells them to the rest of the world, and buys the latter products from other countries, collective welfare is maximized thanks to increased overall efficiency. As I said on Bloomberg TV on Friday, we're all better off because Italy makes the pasta and Switzerland makes the watches. But if trade barriers were to require Italy to make its own watches and Switzerland to make its own pasta, the citizens in both countries would probably end up paying more for products they used to buy from abroad, or consuming lesser products made locally, or both.

U.S. citizens in particular have benefitted massively from the fact that most things can be made more cheaply in other countries – and especially developing nations – because wages are lower. This has cost the U.S. a few million jobs, but it has also allowed virtually all Americans to live much better than they would have if they had been limited to buying U.S.-made goods. That's the simple reason why most of the non-food merchandise at Walmart is imported.

To cite one more factor that has made the world a better place, **I describe the behavior of the U.S. in the post-World War II period as "generosity toward the rest of the world stemming from enlightened**

self-interest." Under the Marshall Plan, we gave (not loaned) billions of dollars with which Western Europe rebuilt. Likewise, between 1945 and 1952, General Douglas MacArthur oversaw the reconstruction of Japan and the strengthening of its economy. Since then, the U.S. has (a) distributed extensive foreign aid, (b) invested heavily in healthcare in developing nations, (c) created programs that bring foreign students to the U.S. and vice versa, and (d) beamed positive messages to people throughout the world. These are all instances of generosity. In each "transaction," we gave more than we directly got, and a cynic might say we acted like suckers.

Yes, these things can be described as largesse, but as the National Archive puts it, the Marshall Plan "provided markets for American goods, created reliable trading partners, and supported the development of stable democratic governments in Western Europe." That's a pretty good payoff. People in other countries received lots of freebies, but certainly these programs helped the U.S. by restraining communism, bringing nations into defensive alignment with the U.S., and contributing to the U.S.'s position as the world's most prosperous nation.

Please note that it's not impossible to throw this process into reverse:

- We can antagonize our trading partners and cause our allies to feel like they're being bullied and extorted.
- We can force countries that have depended on us for capital and other forms of assistance to look to China and Russia for these things instead.
- We can convince the rest of the world to invest less in the U.S. and less in U.S. Treasurys.

The first two points can cost us important allies and cause nations to look less favorably on democracy. As my friend Michael Smith says, "You can't antagonize and influence at the same time." And the third point can dramatically influence the U.S.'s fiscal position.

To date, the world's high opinion of the U.S. economy, rule of law, and fiscal solidity has allowed us to hold a "golden credit card," where there's no credit limit and no bill ever comes. This enabled the U.S. to run fiscal deficits in each of the last 25 years and all but four of the last 45, including trillion-dollar-plus deficits in each of the last five years. **In other words, we've been able to live beyond our means**, with the federal government spending more than it takes in via taxes and fees. This has led to one of the worst things about the U.S.: the $36 trillion national debt and the grossly irresponsible behavior in Washington that caused it.

Since I don't expect Washington to suddenly begin to behave responsibly and live with balanced budgets, I'm left to wonder how much longer we can count on that golden credit card.

- Might other countries become less willing to buy U.S. Treasurys? Might they conclude that our fiscal management is unreliable?
- Even if we remain the world's best credit, might they cut back on purchases out of worry, spite, or political motivation?
- What would happen if a Treasury auction failed? (I imagine the Fed would buy the unsold securities, but I'm uncomfortable about it creating the money to do so by crediting banks with deposits with which to buy. In the end, where does the money come from?)
- Will we remain the world's best credit if the dollar comes to be less accepted as the world's reserve currency?
- What would happen to the deficit – and thus the national debt – if buyers demand higher interest rates on Treasurys?

Going all the way back to World War II and longer, the U.S. has been "holding the cards." Trump believes in the strength of the U.S. and in cashing in on it. That's what his moves on tariffs amount to: no longer "throwing the party" for the rest of the world. No longer generosity in the hope of long-term benefits, but rather transactions in which we extract fair value.

I've received a lot of kind responses to Friday's appearance on Bloomberg TV, and I'm going to use a comment from a viewer to bring us to a conclusion on this subject:

> In the 1980s, people like [current Trump economic advisor] Peter Navarro decided that Japan pulling ahead of the US in autos threatened the future of the U.S.
>
> Japan did indeed pull ahead and never looked back.
>
> The U.S. economy has more than doubled in size relative to Japan since then. It has doubled even after allowing for population changes and currency strength. It doubled in spite of losing the lead in autos, **or is it that it doubled partly because of it?** The margins on computer software and jet engines are probably a good deal higher than on mass-market automobiles. (Emphasis added)

Japan exploited its advantages in producing autos, and the U.S. moved on to things in which it could achieve an advantage of its own. **Isn't that exactly the way things should work in dynamic economies?** As I asked in a memo in September, is it a good idea for nations to try to repeal or resist the laws of economics in an effort to make it otherwise?

<u>The Bottom Line</u>

I consider the tariff developments thus far to be what soccer fans call an "own goal" – a goal scored for the other side when a defender accidentally puts the ball into his own team's net. In this way, they're highly analogous to Brexit, and we know how that turned out. Brexit cost the British mightily in terms of GDP, morale, and alliances, and it harmed their reputation for governance and stability. All of this damage was self-inflicted.

I like the way things have gone during my lifetime, which conveniently spans 99% of the post-war period I've been discussing. Some of our government expenditures have certainly been misspent, both at home and abroad, and our national debt is nothing to celebrate. But I've enjoyed living in a peaceful, prosperous, and increasingly healthy world, and I'm not eager to see that change. **Just a couple of months ago, the U.S. economy was performing well, the outlook was positive, the stock market was at an all-time high, and there was much talk about American exceptionalism. Now, if Trump's tariffs are put into effect, the U.S. economy is likely to experience a recession sooner than otherwise would have been the case, higher inflation, and extensive dislocation.** Even if the tariffs are reversed entirely, it's unlikely the other nations will dismiss this incident and conclude that they have nothing to worry about in terms of relations with the U.S.

No one should rule out the achievement of some of the goals of tariffs listed on page 3. U.S. manufacturing could increase, bringing new jobs and more dependable supply chains. Our treatment in world trade could become fairer. And the Treasury's take could increase.

On the other hand, some of the hoped-for benefits are probably beyond reach. In particular, as for reducing our trade deficit, the U.S. is unlikely to ever buy as less from other countries than they buy from us as long as the U.S. is bigger and more prosperous and thus has greater buying power. This will be especially true as long as our workers are better paid, meaning most U.S.-made goods cost more than goods produced elsewhere.

The hoped-for results might materialize, or the negative consequences might be felt, or some combination of the two. Importantly, however, it must be noted that **any gains that come are likely to arrive in the long run, following a multi-year period of adjustment, whereas the costs will probably be felt almost immediately.**

And what about the financial markets? In the last few days there's been a massive shift in the economic outlook and a huge stock market decline in reaction. As always, the key question surrounds the appropriateness of the response to date: has it been just right, inadequate, or excessive? It's even harder to answer that question than usual. **On the one hand, if the tariffs remain as announced and retaliation leads to an all-out trade war, the economic consequences could be truly dire. But on the other hand, cooler heads (and highly negative political and stock-market reactions) could prevail, causing the tariffs to be rolled back to less harmful levels, perhaps leading to a win for free trade.**

How is the Fed likely to respond? The threat of recession might call for accelerated rate cuts to bolster economic activity. Or the threat of inflation might cause rates to stay higher, with cuts postponed. Note, however, that inflation-fighting measures such as higher rates are probably less likely to succeed against inflation caused by the addition of tariffs to selling prices than they would be against the more typical demand-driven inflation. Today's title is particularly applicable to the Fed's actions: certainly nobody knows.

In Oaktree's markets, fear of defaults (not unfounded) has caused risk compensation in the form of yield spreads to increase substantially, but a flight to the safety of U.S. Treasurys has caused Treasury prices to increase and thus Treasury yields to decline. The net result has been a fair-sized net increase in the available yields on credit. At the same time, we anticipate a higher incidence of distress and increased demand for bespoke capital solutions, meaning we're likely to invest our latest opportunistic debt fund faster than otherwise would have been the case.

To paraphrase Mark Twain, there are themes that rhyme throughout history. For that reason, just as I recycled the title of my post-Lehman bankruptcy memo for this one, I'll also borrow its closing paragraph:

> Everyone was happy to buy 18-24-36 months ago, when the horizon was cloudless and asset prices were sky-high. Now, with heretofore unimaginable risks on the table and priced in, it's appropriate to sniff around for bargains: the babies that are being thrown out with the bath water. We're on the case.

On a personal note, I was fortunate to visit investors in Montreal on the day of the tariff announcement and in Toronto the day after. What a time for a trip to Canada! I started each meeting by saying I'm one of the hundreds of millions of Americans who respect Canada and consider it a friend and ally. The reception was stirring. **This is a good time for all of us to connect with our fellow citizens of the world.**

April 9, 2025

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