Excerpts of

Howard Marks' Memos to Clients

~ Anil K Tulsiram

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MY OBSERVATIONS

Howard Mark is more into convertibles and high yield bonds. He left mainstream equity research sometime in 1978.

Few repeated themes:

1. Firm believer in cycles.
2. Credit cycle is most volatile and strongest. It deserves most attention.
3. Change in business cycle exaggerated by operating and financial leverage.
4. Contrary investment
5. Investing in inefficient market
6. Put avoiding losses ahead of the pursuit of profits.
7. Change in the availability of credit is a powerful force
8. Emphasis a lot that there is so much one cannot know or predict so diversify.
9. Two main risk a) Risk of losing money b) Risk of losing opportunities and its very difficult to do both at the right time.
10. Does not spend much time in analysing how fast corporate profits will grow but believed it will grow in mid-teens. (2002-11,
11. Very difficult to beat the market in the long term (2002-11,
12. 2010 recovery is too fast. In current uncertain world invest in solid and stable companies. Avoid cyclicals and leveraged companies
13. US recovery will be sluggish rather than V shaped (Nov-11)

PRICE MATTERS MORE THAN QUALITY OF INVESTMENTS

Everything is triple AAA at the right price: We are less concerned with the absolute quality of our companies than with the price we pay for whatever it is we're getting. In short, we feel "everything is triple-A at the right price". We have many reasons for following this approach, including the fact that relatively few people compete with us to do so. But we feel buying any asset for less than it's worth virtually assures success. Identifying top quality assets does not; the risk of overpaying for that quality still remains.

Ceteris paribus -- in this case, holding the level of supply constant -- price will be higher if there is more demand and lower if there is less. And that's why buying when everyone else is can, in and of itself, doom an investment. Conversely, buying what no one else will buy at any price almost assures eventual success, and that leads to a discussion of the current level of demand for convertibles and its impact on their prices.

CONTRARIAN INVESTMENTS:

When everyone shrinks from a security because it's "too risky," the few who will buy it can do so with confidence, secure in the knowledge that the price has not been bid up, and in the likelihood that others will eventually outgrow their fear and jump on the bandwagon.

But too many investors drive looking in the rear-view mirror. As someone at my former place of employment once told clients, "We're buying the oils; they've been good to us." We'd rather buy what has performed badly or is the subject of negative bias and thus is cheap. We feel strongly that high yield bonds qualify today, and we'd be glad to talk more about them, or about the opportunities in other areas.

If you're going to succeed at all in timing cycles, the only possible way is to act as a contrarian: catch some opportunities at the bottom, let your optimism abate as prices rise, and hold relatively few exposed positions when the top is reached. To find bargains at the bottom, you don't have to think that things will get better forever; you just have to remember that every cycle will turn up eventually, and that prices are lowest when it looks like it won't. But it's just as important to avoid holding at (and past) the top, and the key is not to succumb to the popular delusion that "trees will grow to the sky".

What I think is important is that, although markets can be underpriced or overpriced and yet go on for months or years to become even more so, **it's most prudent to be optimistic when no one else is, and it can be highly profitable. But it can be dangerous to be optimistic when everyone else is, and very costly.**

My bottom line is that while the best bargains are found when it looks like things can't get better, bargains are hard to find when things can only get worse -- especially if few people seem to know it. That's why Oaktree always tries to keep in mind where we stand, to buy avidly only when fear is at a high level, and to utilize asset classes, strategies and tactics that prepare us for the negatives that are always lurking out there somewhere.

You may wonder from time to time about the high level of confidence exhibited by your managers. But bear in mind that the most profitable investments are unconventional, and maintaining unconventional positions can be lonely. When you buy something you think is cheap and then see its price fall, it takes a strong ego to conclude it's you who's right, not the market. So ego strength is necessary if a manager is going to be able to make correct decisions despite Swensen's "variance from popular opinion." **Oh yeah, one last thing: those strongly-held views had better be right. Few things are more dangerous than an incorrect opinion held with conviction and relied on to excess.** The most important thing is investing defensively.

Because of the fluctuation of both fundamental developments and investor behavior, assets are sometimes offered for sale at bargain prices and at other times at prices that are too high. A technique that works most dependably is putting money into things that are out of favor. Although investors often seem not to grasp it, it shouldn't be hard to understand: **only unpopular assets can be truly cheap. And those that are in favor are likely to be dear.** For example, one of the best reasons for the profitability of distressed debt over the years is that there's no such thing as a distressed company everybody loves. By the time they've made their way to our arena, distressed debt companies can no longer

be on what I call "the pedestal of popularity." **We buy at low dollar prices from depressed owners at a time when corporate performance is well off from the top. Not a bad formula.** Certainly that doesn't have to mean that the investment's cheap enough, but at least there's a low probability it's pumped up on hot air (or investors' ardor). The momentum player buys what's up and bets that it'll keep going up. The style devotee buys one thing whether it's up or down. But the contrarian, or value investor, buys something that other people aren't interested in, in the belief that it's cheap and will become less cheap someday. There's no sure recipe for profit, but I think this one stacks the cards in your favor. **As Sir John Templeton put it, "To buy when others are despondently selling and to sell when others are euphorically buying takes the greatest courage but provides the greatest profit."**

Because of my views on market efficiency and its ramifications, I made a conscious decision 25 years ago to work exclusively in markets I believe are inefficient. It's there that hard work and skill can pay off dependably. Common sense (and the record) suggests that if investors are going to earn superior risk adjusted returns, it's not likely to be by doing the same things everyone else is doing. **The best and most safely earned profits are apt to be found outside the mainstream, not inside.**

The optimist tends more often than not to be a growth investor; he's confident that above-average growth can be perpetuated and that he can identify the companies that'll do so. The more cautious investor looks for value – for tangible attributes that can be counted on for price support even if confidence in the company proves to be unwarranted.
Our school of investing puts great emphasis on being a contrarian. If you want to buy something of solid value, and you want to buy it for less than it's worth, you'll have a better chance if you look among assets, companies and markets that are out of favor. Thus we're happiest when we're not part of the herd; we prefer to watch the herd's extreme boom-bust behavior and profit from its mistakes. Most other investors seem to be happy when they're part of the herd and following the trend.

We believe that because there's so much we can't know about the future, we should invest only where our analysis tells us the worst case is tolerable. We try to avoid situations that entail high expected returns but also a meaningful chance of being wiped out. Peter Bernstein put it simply but elegantly in "Economics and Portfolio Strategy," January 1, 2003: In making decisions under conditions of uncertainty, the consequences must dominate the probabilities. We never know the future. (March, 2003)

ON VENTURE CAPITAL RETURNS DURING TECH BUBBLE:

In my experience, the big, low-risk profits have usually come from investments made at those times when recent results have been poor, capital is scarce, investors are reticent and everyone says "no way!" Today, great results in venture capital are in the headlines, money is everywhere, investors are emboldened and the mantra is "of course!"

BEWARE OF GENERALIZATIONS

– Most of the time, and especially at the extremes, markets over-generalize. Last year, investors acted as if all of the telecom companies would succeed; this year, investors seem to think they're all losers. In 1996 and 1997, financial institutions would lend to anyone; now, even strong companies have trouble getting capital. When the market "throws the baby out with the bathwater," as we believe it's doing now, gems can often be found among the wreckage.

We at Oaktree believe strongly in **contrarianism**. Leaning away from the direction chosen by most others. Sell when they're euphoric, and buy when they're afraid. Sell what they love, and buy what they hate. Closely related to contrarianism is **skepticism**. It's a simple concept, but it has great potential for keeping us out of trouble. If it sounds too good to be true, it probably is. That phrase is always heard after the losses have piled up – be it in dot-coms, portfolio insurance, "market neutral" funds or the "Asian miracle." Oaktree was founded on the conviction that free lunches do exist, but not for everyone, or where everyone's looking, or without hard work and superior skill. Skepticism needn't make you give up on superior risk-adjusted returns, but it should make you ask tough questions about the ease of accessing them.

Lord Keynes wrote "speculators accept risks of which they are aware; investors accept risks of which they are unaware." As Keynes's definition makes clear, investing in the stocks of great companies that "everyone" likes at prices fully reflective of greatness is enormously risky. We'd rather buy assets that people think little of; the surprises are much more likely to be favorable, and thus to produce gains. No, great companies are not synonymous with great investments . . . or even safe ones.

ETORRE'S OBSERVATION: THE OTHER LINE MOVES FASTER. (SEPT 2002)

Finding Your Way on an Efficient Highway – Some people find it difficult to understand the concept of efficient markets, and how efficiency makes it hard for investors to outperform. It's really for this that a crowded highway is the perfect metaphor. Most drivers share the same goal: we want to get there as quickly as possible, with safety. A few people drive like slowpokes, sacrificing speed for excessive safety, and a few others are maniacs who keep the pedal down without a care. The vast majority of us, however, conduct ourselves reasonably but really would like to cut our travel time. As we drive along, we see from time to time that another lane is moving faster than ours. Just as obviously, however, we know that jumping to that lane is unlikely to bring much net improvement.

And that's where the metaphor comes in. If I could switch to the faster lane while everything remained unchanged, doing so would cut my travel time. **But everyone sees which lane is moving fastest, and if everyone switches into that lane, that will make it the slow lane.** Thus the collective actions of drivers alter the environment. In fact, they create the environment.

Over the years, performance has constantly improved in areas like golf. That's because while the participants develop new tools and techniques, the ball never adjusts and the course

doesn't fight back. But investing is dynamic, and the playing field is changing all the time. The actions of other investors will affect the return on your strategy. Just as nature abhors a vacuum, markets act to eliminate an excessive return.

In contrast, highways – like markets – are dynamic environments. What the other participants do on a given day goes a long way toward determining what will and will not work for us. When people flock to the fast lane, they slow it down. And with the lane they left suddenly less crowded, it speeds up. **This is how the "efficient market" in travel acts to equalize the speed of the various lanes, and thus to render ineffective most attempts at lane-picking. Efficient securities markets work the same way to eliminate excess returns**.

Everyone knows what has worked well to date. Just as they know which lane has been moving fastest, they know which securities have been performing best. Most people also understand there is no guarantee that past performance will continue. **What is a little less widely understood, however, is that past returns influence investor behavior, which in turn alters future performance.**

While investors have the option of switching into the securities that have been performing best, most know the outperformance isn't likely to last forever. It takes a little more insight, however, for them to comprehend that their switching will be, in itself, among the things that change performance. When people switch to the better-performing group, their buying bids up the prices of those securities. That bidding-up prolongs the outperformance somewhat, but it also reduces the prospective return and increases the probability of a correction. (The higher the price you pay, the worse your prospects for profit. This seems like a simple concept, but it's forgotten once in a while – as it was in the tech bubble.)

Of course, the analogy to investing holds beautifully. Knowing which lane to drive in has nothing to do with which lane **has been going fastest**. To chart the best course, one must know which one **will go fastest**. As usual, outperforming comes down to seeing the future better than others, which few drivers on crowded highways can do.

So half the time the lane-jumper moves into a fast-moving lane that keeps going fast, and half the time into one that's just about to slow down. And the slow lane he leaves is as likely to speed up as it is to stay slow. Thus the "expected value" of his lane changing is close to zero. And he uses extra gas in his veering and accelerating, and he bears a higher risk of getting into an accident. Thus the returns from lane changing appear modest and undependable – even more so in a risk-adjusted sense.

Isn't There a Way to Make Good Time? – If crowded highways are truly efficient, and the fast lane is destined to slow down, is there no way to do better than others? My answer is predictable: find the inefficiencies. Go where others won't. Do the things others avoid. We all have our tricks on the road. We'll take the route with the hazards that scare away others – after we've made sure we know the way around I continue to believe there are ways to earn superior returns without commensurate risk, but they're usually found outside the

mainstream. UA shortcut that everyone knows about is an absolute oxymoronU, as is one that's found where the roads are well marked and mapped. The route that's little known, unattractive or out of favor may not be the one that's most popular or least controversial. But it's the one that's most likely to help you come out ahead.

ARE THE BEST SMALL COMPANIES BEST INVESTMENT (MARCH, 2003)

In sum, the authors show that investing in stocks subsequent to their appearance in Business Week's "100 Best Small Companies," on average, provides negative excess returns relative to the benchmarks. The authors identify mean reversion of corporate operating performance, overly optimistic growth projections, and the bidding up of the prices of growth stocks to unrealistic levels as potential factors in this underperformance. The authors conclude that "any attempt to find winning investments from a 'hot growth' listing . . . appears futile."

CONTRA INVESTMENTS - 2006

Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.

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; nonconformists don't enjoy the warmth that comes with being at the center of the herd.

UNCONVENTIONALITY - 2006

Unconventionality is required for superior investment results, especially in asset allocation. As I mentioned above, you can't do the same things others do and expect to outperform.

Unconventionality shouldn't be a goal in itself, but rather a way of thinking. In order to distinguish yourself from others, it helps to have ideas that are different and to process those ideas differently. I conceptualize the situation as a simple 2-by-2 matrix:

	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 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 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.**

Contrarian investing, which is akin to unconventional investing, has been behind many of the greatest successes. But that's not the same as saying all contrarian decisions are successful. As is the case with unconventionality, you should not aim for contrarianism for its own sake, but only when the reasons are good and the actions of the crowd look particularly foolish. If your actions aren't founded on solid logic, (a) they're unlikely to work consistently, and (b) when the going gets tough, you might find it hard to hold on through the lows. David Swensen puts it well in his book, "Pioneering Portfolio Management":

"Contrarian, long-term investing poses extraordinary challenges under the best of circumstances. . . . 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.

When someone says, "I wouldn't buy that at any price," it's as illogical as, "I'll take it regardless of price." The latter can get you killed (see Nifty-Fifty growth stocks in 1969 and tech stocks in 1999), and the former can make you miss an opportunity. When everyone's eager to buy the same thing, it's probably overpriced. And when no one is willing to buy something, it's equally likely to be underpriced.

I WOULD NOT BUY THAT AT ANY PRICE – APRIL, 2007

"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. The foregoing must be what Lord Keynes had in mind when he coined one of my favourite phrases: ". . . 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."

In 1978, triple-A bonds were considered respectable investments, while buying B-rated bonds was viewed as irresponsible speculation. Yet the latter have vastly outperformed the former, few of which remain triple-A today.

Elevated popular opinion, then, isn't just the source of low return potential, but also of high risk. Broad distrust, disregard and dismissal, on the other hand, can set the stage for high returns earned with low risk. This observation captures the essence of contrarianism.

LARGE AMOUNT OF MONEY IS MADE BY BUYING WHAT EVERYBODY UNDERESTIMATES – APR-2007

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. As I wrote in "Dare to Be Great," non-conformists don't get to enjoy the warmth that comes with being at the center of the herd. But it should be clear that when you're one of many buying something, it's unlikely to be a special opportunity. It's only when few others will buy that you can get a bargain.

IF EVERYONE LIKES IT, ITS PROBABLY FAIRLY PRICED OR OVERVALUED – ARPIL, 2007

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

BE A PIONEER - 2006

In my experience, many of the most successful investments have entailed being early. **That's half the reason why I consider the greatest of all investment adages to be: "What the wise man does in the beginning, the fool does in the end."**

While there's no surefire route to investment success, I do believe one of the easiest ways to make money is by buying things whose merits others haven't yet discovered. You ask, "When do you get that chance?" Not often, (and certainly not easily today), but not never.

CONTRA INVESTING AND MARKET INEFFICIENCY -

Everyone craves market inefficiency, but most people are vague on what it means or where it comes from. I've always thought a likely source can be a market niche that most people don't know about, don't understand and don't feel comfortable with. That certainly describes high yield bonds in 1978. It helps to be a pioneer.

Likewise, we were fortunate to turn to distressed debt in 1988. There weren't any distressed debt funds from mainstream financial institutions, and the area was a little-known backwater. What could be more unseemly – and less intuitively attractive – than investing in the debt of companies that are bankrupt or sure to become so? Actually, what else could have been as profitable? Distressed debt buyers have reaped high returns while enjoying the relative safety that comes with paying low prices, investing in asset-rich companies and deleveraging their capital structures.

To take early advantage of areas like these, you have to put your faith in concepts and people, based on logical arguments and analyses but without the benefit of historic performance data. That's how you make the big bucks.

BARGAIN IF NO OPTIMISM IS INCORPORATED IN PRICE (SEPT 2012)

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)?

PUT AVOIDING LOSSES AHEAD OF THE PURSUIT OF PROFITS

Our approach emphasizes the low-risk exploitation of inefficient markets, as opposed to aggressive investment in efficient ones. We restrict ourselves to markets where it is possible to know more than other investors. We put avoiding losses ahead of the pursuit of profits. And we do not seek to employ leverage. Inefficient markets must by definition entail

illiquidity and occasional volatility, but we feel unleveraged and expert investment in them offers investors with staying power the best route to high returns without commensurately high risk.

CONSISTENTLY FINISHING IN THE MONEY IS WHAT MATTERS MOST:

And that brings me to what I feel is a much more appealing sports metaphor, which I clipped from the Wall Street Journal in 1992 but never had occasion to cite until now: the story of golfer Tom Kite. The article was about Kite's having won a major tournament, but the part that interested me dealt with his record up to that time: The bespectacled 42-year-old had won ... over the past 20 seasons some $7.2 million in official prize money, more than any other golfer -- ever. But [he had never before won] one of the sport's "majors" (the U.S. and British Opens, Masters and PGA Championship). That's the way we think it should be done: by consistently finishing in the money, but with no need for headline-grabbing victories. What we think matters isn't whether you hit a home run or win the Masters on any given day, but rather what your long-term batting average is.

AVOID BLACK SWAN EVENTS – MAY, 2008

The Black Swan emphasizes 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. 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.

His book was well times because many of the subsequent infamous recent events satisfy this 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.

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. Because ensuring the ability to do so under adverse circumstances is incompatible with maximizing returns in the good times, investors must choose between the two. **(Also in Dec-2007 letter)**

But is it really that simple? It's easy to say you should prepare for bad days. But how 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 you'll bear is a function of the extent to which you choose to pursue return. The amount safety you build into your portfolio should be based on how much potential return willing to forgo. There's no right answer, just trade-offs. That's why I went on from the 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."**

ON BLACK SWAN EVENT – DECEMBER - 2006

Orin Kramer (the Kramer-Spellman hedge fund) in his speech said "My own view is that we exaggerate the utility of standard performance measures. In general, past performance reflects the interaction of particular historical and market conditions and the judgments and beliefs of managers during that period. In particular, managers may consciously or unconsciously pursue strategies which assume the risk of low-frequency, high-severity outcomes. Strategies which can only be torpedoed by low-frequency events will mostly produce favorable outcomes; identifying the tail risk implicit in such strategies is an extraordinary challenge. **The absence of the severe negative outcome is not, regrettably, proof that it cannot occur**."

In other words, (1) short-term investment performance is not a helpful indicator of ability, (2) good results can arise just because a manager chose a high-risk course and was bailed out by events, and (3) that same course could just as easily have led to disaster . . . and certainly could do so next time. However, it's rare for either managers or clients to recognize the unreliability implicit in short-term results, especially when they're good.

MESSAGE FROM BLACK SWAN – OCTOBER, 2008

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.

Skepticism and pessimism aren't synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive.

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.**

LONG TERM VS SHORT TERM (JULY, 2008)

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.

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.

INVESTMENT PHILOSOPHY:

(1) We accept that we're among the many who do not know what the big-picture future holds.
(2) It is for this reason that we choose to work in inefficient markets where specialization, skill and hard work can add value and lead to above-average performance over time.
(3) Lastly, we feel that because we're not clairvoyant, it's important to acknowledge our limitations and put the highest priority on avoiding losses not executing bold strategies. Thus our "game plan" is directed at avoiding strikeouts and building a high batting average over time, not at hitting a home run each trip to the plate.

Success factors: In my opinion, (a) the three ingredients behind success are timing, aggressiveness and skill, and (b) if you have enough aggressiveness at the right time, you don't need that much skill. But those who have attained their success primarily through well-timed aggressiveness can't be depended on to repeat it -- especially in tough times. When an investment track record is considered, it's essential that the relative roles of these three factors be assessed.

Oaktree is built on the following axioms (among many others):

- We can't know everything about the future, and the "bigger picture" the question, the less we can know the answer.
- We must always expect that something will go wrong and build in margin for error.
- When the market embodies too much greed, we must be conscious of the risk that's present. When it swings too far toward fear, we should take advantage of the bargains that result.
- We must constantly remind ourselves of our limitations and dedicate ourselves to the avoidance of hubris. If our methodologies are valid and our people are talented, hubris is one of the few things that could make us fail.

I listed some of the elements that have been at the foundation of prudent investing during my time in the business and more:

- Pursuing both appreciation and income
- Balancing growth and value investments
- Balancing the desire for gain and the fear of loss
- Buying companies with a history of profitability,
- Caring about valuation parameters,
- Emphasizing cheap stocks,
- Taking profits and reallocating capital,
- Rotating industries, groups and themes,
- Diversifying,
- Hedging,
- Owning some bonds, and
- Holding some cash.

Invest in stocks or sectors that are not co-related with each other for diversification.

SECRET TO RISK CONTROL (MAY-2011)

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.

And what makes for cheapness? In sum, the attitudes and behavior of others.

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.**

INVESTMENT PHILOSOPHY FOR BUYING JUNK BONDS, CAN BE APPLIED TO BUYING STOCKS – APRIL, 2007

(As told by Mike Milken in 1978 to Howard Mark)

- If you buy triple-A or double-A bonds, there’s only one way for them to go: down. The surprises are invariably negative, and the record shows that few top-rated bonds remain so for very long.
- On the other hand, if you buy B-rated bonds and they survive, all the surprises will be on the upside.
- Because the investment process is prejudiced against high yield bonds, they offer yields that more than compensate for the risk.
- Thus you’ll earn a superior yield for having accepted the incremental credit risk, and favorable developments can lead to capital gains as well.
- Your main goal should be to weed out bonds that may default.
- But diversification is essential, too, because some of the bonds you hold will default anyway, and your positions in them mustn’t be large enough to jeopardize the overall return.

What an object lesson! What an epiphany! Buy the stocks of the best companies in America at prices that assume nothing can go wrong? Or buy the bonds of unloved companies at prices that overstate the risk of default, and from which the surprises are likely to be on the upside? Having seen fortunes lost investing in the best, it seemed much smarter to buy the worst at too-low prices.

IF WE AVOID THE LOSERS, THE WINNERS WILL TAKE CARE OF THEMSELVES. (APRIL, 2005)

As you've heard *ad nauseum*, we chose to base Oaktree's approach to money management on a simple motto: "if we avoid the losers, the winners will take care of themselves." Thus we've endeavored to build portfolios that would give us acceptable performance if our expectations weren't fully realized, combined with the possibility of surprises on the upside if they were. We've strived to match market returns in good times and do markedly better in bad times – something that may sound simple but isn't. We chose to work in inefficient markets only, with portfolios that stick closely to their charter.

We'd love to deliver great results every year, but that's simply not possible. Instead, in short, it's our goal to eliminate disasters, so that every year is either good or great. If a money management firm can do nothing other than produce returns that are at least decent every year, it's sure to have an excellent long-term record. I truly can say my colleagues have done so, and that we've made money for our collective clientele every year since Oaktree opened its doors.

FINALLY, CAN MACRO-FORECASTS BE USED TO GAIN AN ADVANTAGE OR FORECAST ARE OF NO VALUE?

I pointed out in my 1993 memo that most of the time, you can't get superior results with inaccurate forecasts **or** with accurate forecasts that reflect the consensus. (This is because the consensus view of the future is already embedded in the price of an asset at the time you buy it). To bring above average profits, a forecast generally must be different from the consensus **and** accurate.

But, as I described in 1993, it's difficult with regard to a non-consensus view of the future (1) to believe in it, (2) to act on it, (3) to stand by it if the early going suggests it's wrong, and (4) to be right. Those who invest based on fringe predictions are often wrong to an embarrassing and costly extent.

This bears out the old adage that **"it's difficult to make accurate predictions, especially with regard to the future**." A lot of adages fit this data. I've heard it said that "even a blind squirrel occasionally finds an acorn," "a stopped clock is right twice every day" and "if you put enough monkeys in a room with typewriters, eventually one of them will write the Bible."

Investing means dealing with the future – anticipating future developments and buying assets that will do well if those developments occur. Thus it would be nice to be able to see

into the future of economies and markets, and most investors act as if they can. Thousands of economists and strategists are willing to tell us what lies ahead. That's all well and good, but the record indicates that their insights are rarely superior, and it's never clear why they're willing to give away gratis their potentially valuable forecasts.

EMBRACING ILLIQUIDITY (JULY- 2009)

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.

JOIN I DON'T KNOW SCHOOL

One thing each market participant has to decide is whether he (or she) does or does not believe in the ability to see into the future: the "I know" school versus the "I don't know" school. The ramifications of this decision are enormous.

If you know what lies ahead, you'll feel free to invest aggressively, to concentrate positions in the assets you think will do best, and to actively time the market, moving in and out of asset classes as your opinion of their prospects waxes and wanes. If you feel the future isn't knowable, on the other hand, you'll invest defensively, acting to avoid losses rather than maximize gains, diversifying more thoroughly, and eschewing efforts at adroit timing.
Of course, I feel strongly that the latter course is the right one. I don't think many people know more than the consensus about the future of economies and markets. I don't think markets will ever cease to surprise, or thus that they can be timed. And I think avoiding losses is much more important than pursuing major gains if one is to achieve the absolute prerequisite for investment success: **survival.**

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.

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."**

The most important thing is being mindful of cycles (and where we stand in them). And I feel cyclicality is one of the few constants in the economy and markets.

So I'm a card-carrying member of the "I don't know school." Not because it makes life more fun, but because it provides guidelines for working within the limitations of an intelligent, highly competitive market (March, 2003)

ON FAILURE OF STRATEGISTS TO FORESEE TMT AND TECH BUBBLE (MARCH, 2003):

If it's so obvious in retrospect, lots of the strategists (whose sole job it is to figure out what's going on and what it means for the future) should have had an inkling at the time. The emperor was as naked as he's ever been, but the brokerage strategists failed to point it out. When I think about the events of the past decade, I conclude that the strategists failed to warn about the risk in stocks because of some combination of (a) their congenital bullishness, (b) Wall Street's vested interest in predicting stock price appreciation, and (c) the serious limitations on knowing what the future holds. Rarely have so many been paid so much for contributing so little.

In an efficient market, there's no chance for superior returns through active management. Active managers need markets that are inefficient. **What are inefficient markets? They're markets where mistakes are made**; where assets sell for prices different from their fair value and thus can be bought for less (or sold for more) than they're worth. In order for those mistakes to occur, there has to be ignorance, inadvertence, opacity, prejudice, emotion, or some other obstacle to objective, insightful decision.

Value of predictions (March, 2003)

“One of my greatest complaints about forecasters is that they seem to ignore their own records. I’ve never heard one say, “I predict such-and-such will happen (and 7 out of my last 10 forecasts were off the mark)” or “I predict such-and-such will happen (and, by the way, I predicted the same thing last year and was wrong). **The amazing thing to me is that these people will go on making predictions with a straight face, and the media will continue to carry them.”**

The average “expert” added little in terms of predicting the future.

It’s not that the forecasters were always wrong; when there was little change, they were often right. It’s just that in times of major changes (when accurate forecasts would have helped one make money or avoid a loss), the forecasters completely missed them. In the years reviewed, the expert consensus failed to predict **all** of the major developments.

Where do these forecasts come from? The answer is simple: If you want to see a high correlation, take a look at the relationship between current levels and predicted future levels. . . In general we can say with certainty that these forecasters were much better at telling us where things stood than where they were going.

Every six months, when the Journal reports on a new survey of forecasts, it takes the opportunity to cite the forecaster in the previous survey who came closest . . . And the truth is that the winner’s accuracy is often startling. . . . [However,] the important thing isn’t getting it right once. It’s doing so consistently. . . As the Journal itself pointed out, “ . . . by giving up the comfort of the consensus, those on the fringes of the economic prediction game often end up on the winning or losing end. . . the winners of six months and one year ago didn’t even get the direction of interest rates right this time.”

None of this provides much encouragement for those who would invest based on guesses about the future. **But neither, apparently, does it provide enough discouragement to make them stop.**

I often write about how difficult it is to anticipate the things that will determine the direction of the market. Think about it: what events in the last five years do you wish you’d seen coming?

The market’s big moves often come in reaction to surprises like these. But most of the time, the consensus anticipates continuation of the status quo (especially when things are going well). Surprises aren’t factored into prices ahead of time (by definition). In the movie that runs inside my head, the members of the “I know” school sagely intone, “We’re not expecting any surprises” (without appreciating the irony). **It’s when surprises occur that big profits are there for the taking – by anyone capable of foreseeing them. It’s just that it’s not that easy.**

it’s all about what investors (and certainly the consensus) don’t know

LET THE DOWN CYCLE PLAY ITSELF, BEFORE STARTED BUYING – JANUARY – 2008

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 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**

(May – 20008) 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.**

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.

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 – 2008)**

FORMULA FOR TAKING ADVANTAGE IN DECLINING MARKET – OCTOBER, 2008

- Have a firm, well-reasoned estimate of an asset's intrinsic value ;
- Recognize when the asset's price falls below its value, and buy;
- Average down if the price goes lower; and
- Be right about the value.

I think first of the above point implies we should maintain a list of potential buys

COUNTER CYCLICAL VS BUY LOW SELL HIGH VS CAPITAL ALLOCATION (NOVEMBER, 2009)

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?**

DISAVOWAL OF MARKET TIMING – MOVING INTO CASH

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.

INVESTMENT PHILOSOPHY (FROM WEBSITE)

The following reflects the investment philosophy and beliefs of Oaktree and its Principals.

Oaktree provides investment management within a limited number of specialized niche markets where we believe the potential for reward outweighs the risk entailed. All of our investment activities operate according to the unifying philosophy that follows:

The primacy of risk control

Superior investment performance is not our primary goal, but rather superior performance with less-than-commensurate risk. Above average gains in good times are not proof of a manager's skill; it takes superior performance in bad times to prove that those good-time gains were earned through skill, not simply the acceptance of above average risk. Thus, rather than merely searching for prospective profits, we place the highest priority on preventing losses. It is our overriding belief that, especially in the opportunistic markets in which we work, "if we avoid the losers, the winners will take care of themselves."

Emphasis on consistency

Oscillating between top-quartile results in good years and bottom-quartile results in bad years is not acceptable to us. It is our belief that a superior record is best built on a high batting average rather than a mix of brilliant successes and dismal failures.

The importance of market inefficiency

We feel skill and hard work can lead to a "knowledge advantage," and thus to potentially superior investment results, but not in so-called efficient markets where large numbers of participants share roughly equal access to information and act in an unbiased fashion to incorporate that information into asset prices. We believe less efficient markets exist in which dispassionate application of skill and effort should pay off for our clients, and it is only in such markets that we will invest.

Macro-forecasting not critical to investing

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.

CYCLES

CYCLES ARE INEVITABLE

Every once in a while, an up-or down-leg goes on for a long time and/or to a great extreme and people start to say "this time it's different." They cite the changes in geopolitics, institutions, technology or behaviour that have rendered the "old rules" obsolete. They make investment decisions that extrapolate the recent trend. And then it turns out that the old rules do still apply, and the cycle resumes. In the end, trees don't grow to the sky, and few things go to zero. Rather, most phenomena turn out to be cyclical.

Economies and world affairs rise and fall in cycles. So does corporate performance. The reactions of market participants to these developments also fluctuate cyclically. Thus price swings usually overstate the swings in fundamentals. When developments are positive and corporate profits are high, investors feel good and often bid assets to prices that more than reflect their intrinsic value. When developments are negative, on the other hand, panicky investors are prone to sell them down to overly cheap levels. So prices sometimes represent high multiples of peak prospects (as they did with technology stocks in the '90s), and sometimes low multiples of trough prospects.

CYCLES' CLOUT IS HEIGHTENED BY THE INABILITY OF INVESTORS TO REMEMBER THE PAST

As John Kenneth Galbraith says, "extreme brevity of the financial memory" keeps participants from recognizing the recurring nature of these patterns, and thus their inevitability:

. . . 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 market larger economic world. There can be few fields of human endeavour 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.

CYCLES ARE SELF-CORRECTING

Cycles are self-correcting and their reversal is not necessarily dependent on exogenous events. The reason they reverse (rather than going on forever) is that trends create the reasons for their own reversal. Thus I like to say **success carries within itself the seeds of failure, and failure the seeds of success.**

Seen through the lens of human perception, cycles are often viewed as less symmetrical than they are. Negative price fluctuations are called "volatility," while positive price fluctuations are called "profit." Collapsing markets are called "selling panics," while surges receive more benign descriptions (but I think they may best be seen as "buying panics"; see tech stocks in 1999, for example). Commentators talk about "investor capitulation" at the bottom of market cycles, while I also see capitulation at tops, when previously-prudent investors throw in the towel and buy.

CYCLES ARE THE RESULT OF HUMAN BEHAVIOUR, HERD INSTINCT AND THE TENDENCY TO PSYCHOLOGICAL EXCESSES, AND THESE THINGS ARE UNLIKELY TO EVAPORATE.

Galbraith cites "the extreme brevity of the financial memory" in explaining why markets are able to move to extremes of euphoria and panic. And few adages have been borne out as often as "What the wise man does in the beginning, the fool does in the end." It is rare for trends to be curtailed at a reasonable point before swinging to the excesses from which they invariably.

As you know, we don't consider ourselves good macro-forecasters (or even people who believe in forecasting). So we certainly are in no position to say when the recession or market pullback will start, how bad it will be...or even that there definitely will be one. But we think we're unlikely to be proved wrong if we say cyclicality is not at an end but rather is endemic to all markets, and that every up leg will be followed by a down leg.

So we conclude that most of the time, the future will look a lot like the past, with both up cycles and down cycles. There is a right time to argue that things will be better, and that's when the market is on its backside and everyone else is selling things at giveaway prices. It's dangerous when the market's at record levels to reach for a positive rationalization that has never held true in the past. But it's been done before, and it'll be done again.

IGNORING CYCLES AND EXTRAPOLATING TRENDS IS ONE OF THE MOST DANGEROUS THINGS AN INVESTOR CAN DO.

People often act as if companies that are doing well will do well forever, and investments that are outperforming will outperform forever, and vice versa. Instead, it’s the opposite that’s more likely to be true.

RESPECT CYCLES

– There's little I'm certain of, but these things are true: Cycles always prevail eventually. Nothing goes in one direction forever. Trees don't grow to the sky. Few things go to zero. In my opinion, the key to dealing with the future lies in knowing where you are, even if you can't know precisely where you're going. **Knowing where you are in a cycle and what that implies for the future is very different from predicting the timing, extent and shape of the**

next cyclical move. And so we'd better understand all we can about cycles and their behavior.

Forecasts are unlikely to help us foresee the movements of the economic cycle. Nevertheless, we must be aware that it exists and repeats. The greatest mistakes with regard to the economic cycle result from a willingness to believe that it will not recur. But it always does – and those gullible enough to believe it won't tend to lose money.

The important thing is to recognize that cycles reverse, and to allow for it. I described in my last memo, "What Lies Ahead?," the manner in which a recession continues until, at the margin, a few participants stop cutting back and decide instead to act in anticipation of better times. I believe this process, and the reverse process that eventually causes growth to stall out, will go on forever. No one knows when the turn will occur, or how far the correcting leg will go, but the odds are against anyone who says, "the business cycle is dead."

How can non-forecasters like Oaktree best cope with the ups and downs of the economic cycle? I think the answer lies in knowing where we are and leaning against the wind. For example, when the economy has fallen substantially, observers are depressed, capacity expansion has ceased and there begin to be signs of recovery, we are willing to invest in companies in cyclical industries. When growth is strong, capacity is being brought on stream to keep up with soaring demand and the market forgets these are cyclical companies whose peak earnings deserve trough valuations, we trim our holdings aggressively. We certainly might do so too early, but that beats the heck out of doing it too late.

YOU CAN'T PREDICT CYCLES, BUT YOU CAN PREPARE (JULY 2004)

All of investing consists of dealing with the future, as I've written before, and the future is something we can't know much about. But the limits on our foreknowledge needn't doom us to failure as long as we acknowledge them and act accordingly.

The **economic cycle** evidences **moderate fluctuations** (although their impact can be profound). Viewed on a long-term graph, it looks like a gentle wave.

The **business cycle** responds to developments in the economy with a **more pronounced effect**, rising and falling as consumers and businesses loosen and tighten their purse strings.

The **profits cycle** reflects an **exaggerated reaction** to changes in the amount of business companies are doing, primarily because of the twin influences of operating leverage (such that operating profits change more than revenues) and financial leverage (such that net income changes more than operating profits).

The **credit cycle** moves **dramatically**, usually oscillating between periods when the capital markets are wide open and periods when they're slammed shut.

The **market cycle** reacts **violently**, as investor psychology magnifies all of the above. Security prices yo-yo in what can often be described as extreme over-reaction.

Everyone's aware of these cycles and their influence on the markets, but it's important that their essence and origin be thoroughly understood. For me that means delving into human nature and emotion. The theme of this memo will be that **the cyclical phenomena that so heavily influence our investment outcomes aren't caused by the operation of institutions or physical laws. Rather, they largely result from people's frailties and excesses**. A thorough understanding of these things can increase an investor's ability to achieve gains and avoid losses.

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. 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. In fact, it is the movement toward the extreme itself that supplies the energy for the swing back.

GREED OR FEAR

The market is driven by **greed or fear and not greed AND fear.** At the times that really count, large numbers of people leave one end of the rope for the other. Either the greedy or the fearful predominate, and they move the market dramatically. **When there's only greed and no fear, for example, everyone wants to buy, no one wants to sell, and few people can think of reasons why prices shouldn't rise.** And so they do – often in leaps and bounds and with no apparent governor.

But eventually, something changes. Either a stumbling block materializes, or a prominent company reports a problem, or an exogenous factor intrudes. Prices can even fall under their own weight or based on a downturn in psychology with no obvious cause. Certainly no one I know can say exactly what it was that burst the tech stock bubble in 2000. But somehow the greed evaporated and fear took over. "Buy before you miss out" was replaced by "Sell before it goes to zero." **It's from the extremes of the cycle of fear and greed that arise the greatest investment profits, as distressed debt demonstrated last year.**

RISK TOLERANCE OR RISK AVERSION

In my opinion, the greed/fear cycle is caused by changing attitudes toward risk. **When greed is prevalent, it means investors feel a high level of comfort with risk and the idea of bearing it in the interest of profit. Conversely, widespread fear indicates a high level of aversion to risk**. The academics consider investors' attitude toward risk a constant, but certainly it fluctuates greatly.Finance theory is heavily dependent on the assumption that investors are risk-averse. That is, they "disprefer" risk and must be induced – bribed – to

bear it. That's the reason why the capital market line slopes upward to the right: investors have to be offered. But there are times when investors ignore the uncertainty and risk of loss associated with higher possible returns and pursue them too avidly.

No, those risk-tolerant attitudes will not persist forever. Eventually, something will intrude, exposing securities' imperfections and too-high prices. Prices will decline. Investors will like them less at $60 than they did at $100.

FULL OR EMPTY

One of the most volatile cycles relates to the willingness of investors to interpret events positively or negatively. Forget the traditional half measures; investors see their glass completely full at some times and totally empty at others. **As a result, there are times when there seems to be no price so high that investors won't pay it, and these inevitably are followed by times when no price is low enough to convince people to buy.**

A simple metaphor relating to real estate helped me to understand this phenomenon: **What's an empty building worth?** An empty building (a) has a replacement value, of course, but it (b) throws off no revenues and (c) costs money to own, in the form of taxes, insurance, minimum maintenance, interest payments, and opportunity costs. In other words, it's a cash drain. When investors are in a pessimistic mood and can't see more than a few years out, they can only think about the negative cash flows and are unable to imagine a time when the building will be rented and profitable. But when the mood turns up and interest in future potential runs high, investors envision it full of tenants, throwing off vast amounts of cash, and thus salable at a fancy price. Fluctuation in investors' willingness to ascribe value to possible future developments represents a variation on the full-or-empty cycle. Its swings are enormously powerful and mustn't be underestimated.

VALUE INVESTING VS. GROWTH INVESTING – (OR VALUE TODAY VS. VALUE TOMORROW)

Interest in "value investing" versus "growth investing" is another phenomenon that fluctuates over time, with the relative popularity of growth investing based heavily on investors' willingness to value the future. It's not just a random fad, but a reflection of a cycle in attitudes.

In my view, all investors try to buy value – that is, to buy something for less than it'll turn out to be worth. The difference between the two principal schools of investing can be boiled down to this:

> "Value investors" buy stocks (even those whose intrinsic value may show little growth in the future) out of conviction that the current value is high relative to the current price.

> "Growth investors" buy stocks (even those whose current value is low relative to their current price) because they believe the value will grow fast enough in the future to produce substantial appreciation.

Thus, it seems to me, the choice isn't really between value and growth, but between value today and value tomorrow. Growth investing represents a bet on company performance that may or may not materialize in the future, while value investing is based primarily on analysis of a company's current worth.

But the two schools' relative performance also depends to a great extent on attitudes that fluctuate cyclically. Optimistic growth investors with big dreams for the future bid up the stocks of companies that they expect to exhibit rapid growth, as they did in 1998-99. Eventually their buying power is spent, their hopes are dashed, or their optimism wanes. Then value investors with their more limited expectations regarding the future have their day in less buoyant times, as they did in 2000-01.

SELLING PANIC

Usually when the price of something falls, fewer people want to sell it and more want to buy it. But in a crisis, "market prices become countereconomic," and the reverse becomes true. F**alling price, instead of deterring people from selling, triggers a growing flood of selling, and instead of attracting buyers, a falling price drives potential buyers from the market (or, even worse, turns potential buyers into sellers.)"** This phenomenon can occur for reasons ranging from transactional (they receive margin calls) to emotional (they just get scared). The liquidity demanders increase in number, and they become more highly motivated.

In times of crisis, liquidity suppliers become scarce. Maybe they spent their capital in the first 10% decline and are out of powder. Maybe the market's increased volatility and decreased liquidity have reduced the price they're willing to pay. And maybe they're scared, too. **"Information did not cause the dramatic price volatility. It was caused by the crisis-induced demand for liquidity at a time that liquidity suppliers were shrinking from the market."**

And clearly, both selling panics and buying panics have more to do with extreme swings in emotion and urgency than they do with fundamental corporate and economic developments.

CREDIT CYCLE

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.**

It is my belief that a willingness to buy new securities in greater quantity invariably is accompanied by a willingness to buy securities of lower quality. Thus lower standards go hand in hand with higher amounts of issuance. When investors are chastened and afraid, they'll buy very few new securities, and only those of high quality. When they're euphoric and confident, they'll buy greater quantities and attend less to matters of quality and downside protection. **In the most overheated markets, when being underinvested is considered the biggest mistake one can make, buyers compete for new issues by paying higher prices and by demanding less in terms of quality and safety.**

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.

JUST GIVE ME MY 10%

In my 34 full calendar years in the investment business, starting with 1970, the annual returns on the S&P 500 have swung from plus 37% to minus 26%. Averaging out good years and bad years, the long-run return is usually stated as 10% or so. Everyone's been happy with that typical performance and would love more of the same.

But remember, a swinging pendulum may be at its midpoint "on average," but it actually spends very little time there. The same is true of financial market performance. Here's a fun question (and a good illustration): for how many of the 34 years from 1970 through 2003 was the annual return on the S&P 500 within plus or minus 2% of "normal" – that is, between 8% and 12%?

OnceU**!** It also surprised me to learn that the return had been more than 20 percentage points away from "normal" – either up more than 30% or down more than 10% – two-thirds of the time: 22 out of the last 34 years. So one thing that can be said with conviction about stock market performance is that **the average certainly isn't the norm.** Market fluctuations of this magnitude aren't nearly fully explained by the changing fortunes of companies, industries or economies. They're largely attributable to the mood swings of investors.

"Buy low, sell high" is the time-honored dictum, but investors who are swept up in market cycles too often do just the opposite. The proper response lies in contrarian behaviour: buy when they hate 'em, and sell when they love 'em. "Once-in-a-lifetime" market extremes seem to occur just once in a decade or so – not often enough to build an investment career around capitalizing on them. But attempting to do so should be an important component of any investor's approach.

Just don't think it'll be easy. You need the ability to detect instances in which prices have diverged significantly from intrinsic value. You have to have a strong-enough stomach to defy conventional wisdom (one of the greatest oxymorons) and resist the myth that the

market's always efficient, and thus right. You need experience on which to base this resolute behavior. And you must have the support of understanding, patient constituencies. Without enough time to ride out the extremes while waiting for reason to prevail, you'll become that most typical of market victims: the six-foot tall man who drowned crossing the stream that was five feet deep on average. **But if you're alert to the pendulum-like swing of the markets, it's possible to recognize the opportunities that occasionally are there for the plucking.**

STAGES OF BULL MARKET:

The first, when a few far-sighted people begin to believe that some improvement is possible, the second, when most investors come to agree that improvement is actually underway, and the third, when everyone believes everything will get better forever.

(During Asian crisis 1998) When markets do not fall despite negative news across the world: Certainly, the secret's out: something bad can happen -- and has. We see Asian currencies, economies and perhaps social orders in free-fall. But what strikes me is the fact that the major U.S. equity indices are just about where they were when I wrote in September. Our market justifiably benefits from a flight to quality, and it is true that many of our companies may not be directly affected by the Asian turmoil. **But are the people pricing stocks near all-time highs too optimistic, too pessimistic, or just right?** Prices near highs and optimism in bloom -- that's a dangerous combination, especially with perceived risk on the rise. Peter Bernstein wrote around 1979 that "The great buying opportunities ... are never made by investors whose happiest hopes are daily being realized." And yet many of today's investors have only known success, and few appear seriously chastened by recent developments. This permits me to conclude that **this is not a buying opportunity and, although no collapse need be imminent, the stock market's best days are behind it for a while.**

And when every expenditure that can be delayed has been delayed, the decline will slow and then stop. Then one person will conclude it's not going to get any worse, or prices any lower. One potential buyer will come off the sidelines and place an order; one worker will be hired to fill that order; and one manufacturer will buy a new machine in anticipation of increased business. And one person will decide to buy a share in a business, or even try to start one. And that's what gets the up-leg going.

The longer I'm in this business, the less I believe in investor agility. Most people seem stuck in positions as bulls, bears or something in between. Most are always aggressive or always defensive. Most either always feel they can see the future or never feel they can see the future. Most always prefer value or always prefer growth. Few people's psyches are flexible enough to allow them to switch from one way of thinking to another, even if they theoretically possessed the needed perspicacity. Rather, most people have a largely fixed style and point of view, and the most they can hope for is skill in implementing it – and I don't exempt Oaktree and myself from that observation.

But that's not so bad. It's my conclusion that if you wait at a bus stop long enough, you're sure to catch your bus, while if you keep wandering all over the bus route, you may miss them all. So Oaktree will adhere steadfastly to its defensive, risk-conscious philosophy and try to implement it with skill and discipline. We think that's the key to successful long-term investing – especially in today's uncertain environment.

PROGRESSION OF MARKET CYCLE (MAY, 2003)

- Favorable developments and positive investor psychology cause prices to rise.
- Reports of price appreciation attract momentum players, who shout, "We'd better get in; who knows how far this can go." Their purchases of already-appreciated assets move prices still higher on a trajectory that appears capable of rising forever.
- Eventually, prices get so high that they vastly exceed intrinsic values.
- A few value-conscious investors step into the crowd to sell. Prices turn down, sagging under their own weight or perhaps because fundamental developments begin to be less favorable.
- Less-favorable developments and less-favorable psychology combine to force prices below intrinsic values.
- The pain of losses becomes so great that investors flee and prices reach giveaway levels. This time it's, "We'd better get out; who knows how far this can go."
- The first iron-nerved contrarians recognize that good values are available and start to buy.
- Others soon follow, and eventually the number of new buyers exceeds the number of sellers. Prices stop falling . . . and begin to rise.
- Reports of rising prices and the bargains obtained by those astute pioneers attract the masses to the marketplace, who shout, "We'd better get in . . . ," and the cycle continues.

What happens when people get excited about an asset class?

- capital floods in,
- prices rise,
- current returns soar, and
- Prospective returns decline.

But don't forget the significant ramifications. Investors lose interest in other asset classes; thus their prices fall (at least in relative terms) and their prospective returns rise. In other words, the popular asset becomes more expensive and the rest get cheaper.

THE CREDIT CYCLE

Change in the availability of credit is a powerful force , and the longer I'm in the investment business, the more I respect the role of the credit cycle. For example, although we hope we added value through our implementation, our 1990 distressed debt funds earned their 50% gross returns largely because (a) fear and the government's actions closed the credit window, (b) the LBOs of the 1980s couldn't refinance their debt and defaulted in

droves, and that debt could therefore be bought for a song. A significant recession contributed to the conflagration, but whereas a generous capital market would have let companies finance their way out of trouble (as they did from 1993 through mid-1998), a tight one brought them down in 1990-92.

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.

The process is simple:

- 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 market share by lowering demanded returns (e.g., cutting interest rates), lowering credit standards, providing more capital for a given transaction, and easing covenants. At the extreme, providers of capital finance borrowers and projects that aren't worthy of being financed. As The Economist said earlier this year, "the worst loans are made at the best of times." This leads to capital destruction – that is, to investment of capital in projects where the cost of capital exceeds the return on capital, and eventually to cases where there is no return of capital.

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 along 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. 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 fuelled. I stated earlier that cycles are self-correcting. The credit cycle corrects itself through the processes described above, and it represents one of the factors driving the fluctuations of the economic cycle. **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**.

In making investments, it has become my habit to worry less about the economic future – which I'm sure I can't know much about – than I do about the supply/demand picture relating to capital. Being positioned to make investments in an uncrowded arena conveys

vast advantages. Participating in a field that everyone's throwing money at is a formula for disaster.

One of the critical elements in business or investment success is staying power. I often speak of the six-foot-tall man who drowned crossing the stream that was five feet deep on average. Companies have to be able to get through the tough times, and cash is one of the things that can make the difference. Thus all of the investments we're making today assume we'll be going into the difficult part of the credit cycle, and we're looking for companies that will be able to stay the course.

DEFENSIVE INVESTING:

Oaktree follows a clearly defined route that it trusts will bring investment success: **If we avoid the losers, the winners will take care of themselves.** We think the most dependable way for us to generate the performance our clients seek is by avoiding losing investments. We don't claim that this is the only way to invest well; others may choose more aggressive approaches, and they may work for them. **This is the way for us.**

Investing defensively can cause you to miss out on things that are hot and get hotter, and it can leave you with your bat on your shoulder in trip after trip to the plate. You may hit fewer home runs than another investor . . . but you're also likely to have fewer strikeouts and fewer inning-ending double plays. The ingredients in defensive investing include (a) insistence on solid, identifiable value at a bargain price, (b) diversification rather than concentration, and (c) avoidance of reliance on macro-forecasts and market timing.

WARREN BUFFETT CONSTANTLY STRESSES "MARGIN OF SAFETY."

In other words, you shouldn't pay prices so high that they presuppose (and are reliant on) things going right. Instead, prices should be so low that you can profit – or at least avoid loss – even if things go wrong. Purchase prices below intrinsic value will, in and of themselves, result in larger gains, smaller losses, and easier exits.

"Defensive investing" sounds very erudite, but I can simplify it: **Invest scared!** Worry about the possibility of loss. Worry that there's something you don't know. Worry that you can make high quality decisions but still be hit by bad luck or surprise events. Investing scared will prevent hubris; will keep your guard up and your mental adrenaline flowing; will make you insist on adequate margin of safety; and will increase the chances that your portfolio is prepared for things going wrong. And if nothing does go wrong, surely the winners will take care of themselves.

AVOIDING BAD YEARS :

All Preparing for bad times is akin to attempting to avoid individual losers, and equally important. Thus time is well spent making sure the downside risk of our portfolios is limited. **There's no need to prepare for good times; like winning investments, they'll take care of themselves.** The mantra "beat the market" has been vastly overdone in the last 25 years, when outperforming an index has become the *sine qua non* of good management. But why should this be the case? **Keeping up with the market while bearing less risk is at least as great an accomplishment, although few people talk about it in the same glowing terms.**

IN THE GOOD TIMES, IT'S GOOD ENOUGH TO BE AVERAGE.

In good times, the average investor makes a lot of money, and that should suffice. In good times the greatest rewards are likely to go for risk bearing rather than for caution. Thus, to beat the averages in good times, we'd probably need to accept above-average risk . . . risk that could turn around and bite us in a minute.

Our goal is to generate performance that is average in good times (although we'll accept more) and far above average in bad times. If in the long run we can accomplish this simple feat (which time has shown isn't simple at all), we'll end up with (a) above-market performance on average, (b) below-market volatility, (c) highly superior performance in the tough times, helping to combat people's natural tendency to "throw in the towel" at the bottom, and thus (d) happy clients. We'll settle for that combination.

Defensive investing, insistence on value, and shying away from leverage -- they're all important. **And much of the reason they're important stems from the fact that so little of short-term performance is under our control.**

That brings up something that I consider a great paradox: I don't think many investment managers' careers end because they fail to hit home runs. Rather, **they end up out of the game because they strike out too often – not because they don't have enough winners, but because they have too many losers.** And yet, lots of managers keep swinging for the fences.

Charley's article ("The losers game by Charles Ellis") described the perceptive analysis of tennis contained in "Extraordinary Tennis for the Ordinary Tennis Player" by Dr. Simon Ramo, the "R" in TRW. Ramo pointed out that professional tennis is a "winner's game," in which the match goes to the player who's able to hit the most winners: fast-paced, well-placed shots that his opponent can't return. But the tennis the rest of us play is a "loser's game," with the match going to the player who hits the fewest losers. The winner just keeps the ball in play until the loser hits it into the net or off the court. **In other words, in amateur tennis, points aren't won; they're lost.**

INVESTMENT AND 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.

I’m always careful to point out that there are many game plans capable of leading to success. Offense or defense. Home runs or batting average. Go for the long bomb, or pick them apart with short passes. Battle from the baseline or rush the net. There are as many choices as there are sports metaphors. But the best game plan will only take you as far as the starting line or the first pitch. Once the game is underway, it comes down to skillful execution. **The best strategy in the world won’t pay off without skillful blocking and tackling. And having a talented, disciplined team that stays together – a rarity in sports or investing – doesn’t hurt.**

SOMETHING CAN GO WRONG:

When I was a kid, my dad used to joke about the habitual gambler who finally heard about a race with only one horse in it. He bet the rent money on it, but he lost when the horse jumped over the fence and ran away. **There is no sure thing** , only better and worse bets, and anyone who invests without expecting something to go wrong is playing the most dangerous game around.

It's always something.” That's what Roseanne Rosanadana used to say on Saturday Night Live, and it's very true -- eventually, something always goes awry. Any course of action which depends on everything going right is unsafe, but such an expectation has to have been behind Long-Term’s 25-plus times leverage. Warren Buffet, with his insistence on "margin for error," would never make such a bet (although he was willing in the hours just before the restructuring.

There are a lot of moving parts in this machine, and many of them are beyond our control. We build portfolios based on the intrinsic values we see and the developments we think will unfold. But uncontrollable factors will have a profound impact on the results. It’s essential to remember that the fact that something’s probable doesn’t mean it’ll happen, and the fact that something happened doesn’t mean it wasn’t improbable. **So we educate our clients as to what they can fairly expect, and we count on them to bear in mind the difference between probabilities and outcomes.**

And the investors I like most are patient. Because they know they can’t be right every time, their real concern is with the long run. On the other hand, the “I know” investor feels he has a good handle on what lies ahead and thus plans to do an above-average job every year – an admirable goal, perhaps, but I don’t think highly achievable

FUTURE POSSIBILITIES COVER A BROAD RANGE – NOVEMBER, 2009

Wallstreet 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.

NEVER FORGET THE 6'-TALL MAN WHO DROWNED CROSSING THE STREAM THAT WAS 5' DEEP ON AVERAGE - NOVEMBER, 2009

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**.

LEVERAGE

LEVERAGE OK ONLY FOR STABLE BUSINESS – DECEMBER, 2008

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).

ARE YOU TALL ENOUGH TO USE LEVERAGE? – DECEMBER 2008

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.**

LESSONS FROM 2008 CRISIS ON LEVERAGE – DECEMBER, 2008

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.**

BEWARE OF HIDDEN LEVERAGE (JULY 2009)

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.

RISK

WE DO NOT PREACH RISK-AVOIDANCE.

In fact, the knowing acceptance of risk for profit is at the core of much of what we do, and we feel there is an important role today for investing which is creative and adaptable. But we would take this opportunity to exhort you to review most critically the risk associated with your current and contemplated investments, and not to be among those who uncritically joined the trend toward risk. Whatever investment opportunities you decide on, we would encourage you to stress thorough appraisal of the risks entailed and cautious implementation. **What is it that distinguishes the investment opportunities we'd suggest you pursue today? Not just the offer of high returns, but of returns which are more than proportionate to the risk entailed**.

One of the top managers quoted "If you want to be in the top 5% of money managers, you have to be willing to be in the bottom 5%, too." Our way" is never to tolerate poor performance, and certainly not to consider it an acceptable side-effect of swinging for the fences.

On being overly cautious:

In the interest of full disclosure, I want to mention here that I've been contemplating the possibility that my views on these matters are too cautious and short-sighted. My conclusion is that I am a product of my experience. (Talks about going through severe bear market of 1973-74 where Nifty-Fifty stocks declined by 70-90%.) Maybe I spend too much of my time worrying about the next bear market; I've been conditioned to do that. And maybe I'm wrong. But Oaktree's clients needn't worry that we'll manage their portfolios based on the assumption that a correction is imminent. We believe strongly that "it's one thing to have an opinion but quite another thing to act as if it's right." So while we take some defensive steps in portfolios as our caution grows, we're always fully invested and just as ready for a market rise as we are decline.

Am I right or wrong in being this cautious? No one can say. Does my mindset, and Oaktree's resultant approach to investing, cost us profits in good years? Probably. Are we well prepared for bad times and untoward developments, and are we happy with that? Absolutely. If we insist on a degree of defensiveness that turns out to be excessive, the worst consequence should be that your profits will be a little lower than they otherwise might have been. I don't think that's the worst thing in the world. And in the end, I think the skill, experience and discipline of Oaktree's people will continue to make up for its lower risk profile and keep our long-term returns more than competitive.

MOST OF THE TIME, RISK BEARING WORKS OUT JUST FINE – DECEMBER, 2007

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's going on**

RISK IS INVISIBLE BEFORE THE FACT – DECEMBER, 2007

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. Or as Peter Bernstein puts it, "Risk means more things can happen than will happen . . ." 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.

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 this past 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.

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 67 years ago: ". . .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 really doesn't work, and people are reminded what risk's all about.**

BEARING RISK FOR PROFIT (JANUARY – 2006)

A few years ago, one of my memos quoted Lord Keynes as having 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." (I admitted at the time that I'd been unable to verify that he actually said it, but now I've identified the source.) Keynes makes an essential point. **Bearing risk unknowingly can be a huge mistake**, but it's what those who buy the securities that are all the rage and most highly esteemed at a particular point in time – to which "nothing bad can possibly happen" – repeatedly do. **On the other hand, the intelligent acceptance of recognized risk for profit underlies some of the wisest, most profitable investments** – even though (or perhaps due to the fact that) most investors dismiss them as dangerous speculations.

What does it mean to intelligently bear risk for profit? I'll provide an example. In the early 1980s, a reporter asked me, "How can you invest in high yield bonds when you know some of the issuers will go bankrupt?" Somehow, the perfect answer came to me in a flash: "The most conservative companies in America are the life insurance companies. How can they insure people's lives when they know they're UallU going to die?" Both activities involve conscious risk bearing. Both can be done intelligently (or not). The ability to profit from them consistently depends on the approach employed and whether it's done skillfully. For companies selling life insurance, I said, the keys to survival and profitability are the following:

It's risk they're aware of. They know everyone's going to die. Thus they factor this reality into their approach.

It's risk they can analyze. That's why they have doctors assess applicants' health.

It's risk they can diversify. By ensuring a mix of policyholders by age, gender, occupation and location, they make sure they're not exposed to freak occurrences and widespread losses.

And it's risk they can be sure they're well paid to bear. They set premiums so they'll make a profit if the policyholders die according to the actuarial tables on average. And if the insurance market is inefficient – for example, if the company can sell a policy to someone

likely to die at age 80 at a premium that assumes he'll die at 70 – they'll be better protected against risk and positioned for exceptional profits if things go as expected.

We do exactly the same things in high yield bonds, and in the rest of Oaktree's strategies. We try to be aware of the risks, which is essential given how much our work involves assets that some simplistically call "risky." We employ highly skilled professionals capable of analyzing investments and assessing risk. We diversify our portfolios appropriately. And we invest only when we're convinced the likely return far more than compensates for the risk.

We've said for years that risky assets can make for good investments if they're cheap enough. The essential element is knowing when that's the case. That's it: the intelligent bearing of risk for profit, the best test for which is a record of repeated success over a long period of time.

RISK MANAGEMENT VS. RISK AVOIDANCE – JANUARY 2006

Clearly, Oaktree doesn't run from risk. We welcome it at the right time, in the right instances, and at the right price. We could easily avoid all risk, and so could you. But we'd be assured of avoiding returns above the risk-free rate as well. Will Rogers said, "TYou've got to go out on a limb sometimes because that's where the fruit is." None of us is in this business to make 4%.

BEHAVIOURAL RISK (NOVEMBER – 2009)

[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 . **(Extract from report by Ian Kennedy and Richard Riedel of Cambridge Associates, entitled "Behavioral Risk,")**

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 longterm investors it is dead wrong. . . . **As equity markets plummet, investors' risk aversion rises even as the fundamental risk is in fact declining**.

"IF WE AVOID THE LOSERS, THE WINNERS WILL TAKE CARE OF THEMSELVES.

We're much more concerned about participating in a loser than we are about letting a winner get away. In my experience, long-term investment success can be built much more reliably on the avoidance of significant losses than it can on the quest for outsized gains. A high batting average, not a swing-for-the-fences style, offers the most dependable route to success."

FOCUSING ON WRONG RISK (JULY 2009)

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.
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.

LONG RUN

Worry about time – Another element that investors ignore in their optimism is time. It seems obvious, but long-term trends need time in order to work out, and time can be limited. Or as John Maynard Keynes put it, "Markets can remain irrational longer than you can remain solvent." Whenever you're tempted to bet everything on a long-run phenomenon, remember the six-foot tall man who drowned crossing the stream that was five feet deep on average. One of the great delusions suffered in the 1990s was that "stocks always outperform." I agree that stocks can be counted on to beat bonds, cash and inflation, as Wharton's Prof. Jeremy Siegel demonstrated, but only with the qualification "in the long run."

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

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

The bottom line is that risk of fluctuation is always present. Thus stocks are risky unless your time frame truly allows you to live through the downs while awaiting the ups. Lord Keynes said "markets can remain irrational longer than you can remain solvent," and being forced

to sell at the bottom – by your emotions, your client or your need for money – can turn temporary volatility (the theoretical definition of risk) into very real permanent loss. Your time frame does a lot to determine what fluctuations you can survive.

In the long run, investing is about value and the expectation that, eventually, price will catch up. But in the short run it's about psychology, emotion and popularity. The influence of those three factors comes through their effect on flows of capital, and in the short run it's capital flows that have the most profound impact of all. **(May, 2003)**

DIFFICULT TO BEAT THE MARKET IN THE LONG RUN (2002-11)

Very few people are skillful enough to outperform through thick and thin. As I've said before, the attention paid to people like Warren Buffett and Peter Lynch is a tribute to their uniqueness and demonstrates the meaning of the phrase, "it's the exception that proves the rule." The rule is that few people can beat the market for long.

INVESTING BASED ON SINGLE SCENARIO OF COMPLETE DOOM IS NOT ADVISABLE

So What Do We Do Now (after Sept 11 bombing)? We could assume that the combination of further weakening of the already-weak economy plus continued terrorism will make for a very difficult environment. If we then based our investment process on that assumption, we would hold cash and make very few commitments. I call this "single scenario investing." The problem, obviously, is that arranging our portfolio so that it will succeed under a scenario as negative as that means setting it up to fail under most others. We do not believe in basing our actions on macro-forecasts, as you know, and we certainly don't think we could ever be that right.

Thus Oaktree will continue to invest under the assumption that tomorrow will look a lot like yesterday – an assumption that to date has always proved correct. At the same time, we will continue to insist on an investment process that anticipates things not always going as planned, and on selections that can succeed under a wide variety of scenarios. As long-term clients know, this part of the story never changes. In the current environment, we will allow a very substantial margin for error. We will continue to work only in inefficient markets, because we feel it's there that low risk needn't mean low returns, and upside potential can coexist with downside protection.

And we will continue to strive for healthy returns in good markets and superior returns in bad markets. We do not promise to beat the markets when they do well, but we also don't think that's an essential part of excellence in investing.

EVEN IN A MELTDOWN LIKE 2008, WE HAVE NO CHOICE BUT TO ASSUME THAT THIS ISN'T THE END – SEPTEMBER, 2008

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 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 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 you bought credit insurance on all of your holdings: who would be able to make good 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?

BE PREPARED FOR ONCE IN A GENERATION EVENT, BUT YOU CANNOT INVEST VALUING EVERYTHING FOR WORST CASE SCENARIO – DECEMBER - 2008

One of my favourite 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.

If every portfolio was required to be able to withstand declines on the scale we've witnessed this year [2008] 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**

PROBABILITY OF HAPPENING IS MORE IMPORTANT – OCTOBER 2008

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).

MOST PEOPLE VIEW THE FUTURE AS LIKELY TO REPEAT PAST PATTERNS – JANUARY 2010

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.

WHAT TO BUY UNDER CURRENT UNCERTAINTY – SEPTEMBER 2008

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.

(SEPT-2010):

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.

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.

HIGHLY UNCERTAIN WORLD (JULY 2009)

Peter Bernstein said "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

POWERFUL RALLY OF 2009 NOT JUSTIFIED, INVESTORS NEED TO BE MORE CAREFUL WHILE INVESTING – JANUARY 2010

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

POSSIBILITIES HAS A SUBSTANTIAL LEFT-HAND (I.E., NEGATIVE) TAIL – JANUARY, 2010

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 longterm norms, and investor behavior should be prudent. 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.

THE RIGHT APPROACH FOR TODAY (MAY-2011)

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 [prepare yourself] 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.)

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.

BELIEVE IN OPERATING IN INEFFICIENT MARKETS

At Oaktree we don't spend our time attempting to guess at the future direction of economies, rates and markets, things about which no one seems to know more than anyone else. Rather, we devote ourselves to specialized research in market niches which others find uninteresting, unseemly, overly complicated, beyond their competence or not worth the effort and risk. These are the inefficient markets in which it is possible to gain a "knowledge advantage" through the expenditure of time and effort. They also happen to be markets in which micro factors relating to companies, assets and securities matter the most. This is where it's possible to find bargains, and only bargain purchases can be counted on to dependably lead to returns which are above-average relative to the risk entailed. We say "**we try to know the knowable" -- and that doesn't include the macro-future** .

DON'T IGNORE THEORY COMPLETELY:

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. We can buy securities for their returns but ignore their risk. We can buy fifty correlated securities and mistakenly think we've diversified. When I think of the impact of being blind to theory, I flash back to 1970 and the frighteningly simplistic rationale behind

my colleagues' expectation of 12% a year from stocks: if they could emulate the historic 10% return with ease through indexing, it should be a snap to add a couple of percent with just a little effort.

The key turning point in my investment management career came when I concluded that hard work and skill would pay off best in inefficient markets. Theory informed that decision and prevented me from wasting my time elsewhere, but it took an understanding of the limits of the theory to keep me from completely accepting the arguments against active management. Theory and practice have to be balanced in this way. Certainly neither alone is enough.

TECHNOLOGY BOOM AND BUST

"Our reservation here is that (a) technology, like everything else in life, is cyclical; and (b) **there's something *goofy* about the price of a stock discounting as much as a century of earnings for a company in a field where change is the only constant and where the pace of change is constantly quickening**." (Emphasis added)

The technology, Internet and telecommunication craze has gone parabolic in what is one of the great, if not the greatest, manias of all time ... The history of manias is that they have almost always been solidly based on revolutionary developments that *eventually* change the world. Without fail, the bubble stage of these crazes ends in tears and massive wealth destruction ... Many of the professional investors involved in these areas know that what is going on today is madness. However, they argue that the right tactic is to stay invested as long as the price momentum is up. When momentum begins to ebb, they will sell their positions and escape the carnage. Since they have very large positions and since they all follow the same momentum, I suspect they are deluded in thinking they will be able to get out in time, because all other momentum investors will be doing the same thing. (Emphasis added)

RADIO BOOM

On changing the world: I have absolutely no doubt that these movements are revolutionizing life as we know it, or that they will leave the world almost unrecognizable from what it was only a few years ago. The challenge lies in figuring out who the winners will be, and what a piece of them is really worth today**.**

The graph at the left shows the stock price performance of the leading company in an industry that was thought capable of changing the world. For that reason, the stock followed the explosive price pattern that has become typical for technological innovators. The predictions were correct: the industry did change the world, and the company was its big winner. The industry was radio. In the 1920s it was expected to change the world, and it did. Its ability to communicate without wires created entertainment in the home, electronic advertising and the live delivery of events. The company was RCA, and as the

industry leader its stock rose from $8 in mid-1927 to $114 in mid-1929.
While part of the stock's appreciation was due to the market boom in which it shared, certainly part was also due to an overvaluation of its potential. After the onset of the Great Crash, RCA's stock fell from that high of $114 to $2½ within three years. The Depression can be blamed for some of this decimation, but it is worth noting that even 25 years after the 1929 peak, when the Depression and World War II were well over and the post-war recovery was underway, RCA's stock had yet to get back to a third of its earlier high. The times, the industries and the companies are certainly different today, but it makes one wonder whether investors aren't again overpaying for the ability to change the world.

As usual, Buffet puts it as succinctly as anyone could: **"The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage.** The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors."

We have no alternative to assuming that the future will look mostly like the past, but we also must allow for the fact that we face a range of possible futures today that is wider than usual. In other words, I feel we must allow for greater-than-normal uncertainty.

FOOLED BY RANDAMNESS AND LUCK

ROLE OF LUCK (2002-11)

Randomness (or luck) plays a huge part in life's results, and outcomes that hinge on random events should be viewed as different from those that do not. Thus, when considering whether an investment record is likely to be repeated, it is essential to think about the role of randomness in the manager's results, and whether the performance resulted from skill or simply being lucky.

$10 million earned through Russian roulette does not have the same value as $10 million earned through the diligent and artful practice of dentistry. They are the same, can buy the same goods, except that one's dependence on randomness is greater than the other. To your accountant, though, they would be identical. . . . Yet, deep down, I cannot help but consider them as qualitatively different. (p. 28)

Every record should be considered in light of the other outcomes – Taleb calls them "alternative histories" – that could have occurred just as easily as the "visible histories" that did.

Clearly my way of judging matters is probabilistic in nature; it relies on the notion of what could have probably happened. (p.29)

If we have heard of [history's great generals and inventors], it is simply because they took considerable risks, along with thousands of others, and happened to win. They were intelligent, courageous, noble (at times), had the highest possible obtainable culture in their day – but so did thousands of others who live in the musty footnotes of history. (p. 35)

Think about the aggressive backgammon player who can't win without a roll of double sixes. He accepts the cube – doubling the stakes – and then gets his "boxcars." It might have been an unwise bet, with its one-in-36 chance of success, but because it succeeded, everybody considers him brilliant. We should think about how probable it was that something other than double sixes would materialize, and thus how lucky the player was to have won. **This says a lot about his likelihood of winning again**.

As my friend Bruce Newberg says over our backgammon games, "there are probabilities, and then there are outcomes." **The fact that something's improbable doesn't mean it won't happen. And the fact that something happened doesn't mean it wasn't improbable. (I can't stress this essential point enough.) Every once in a while, someone makes a risky bet on an improbable or uncertain outcome and ends up looking like a genius. But we should recognize that it happened because of luck and boldness, not skill**.

In the short run, a great deal of investment success can result from just being in the right place at the right time. I always say the keys to profit are aggressiveness, timing and skill, and if you have enough aggressiveness at the right time, you don't need that much skill. My image is of a blindfolded dart thrower. He heaves it wildly just as someone knocks over the target. His dart finds the bulls-eye and he's proclaimed the champ.

. . . at a given time in the markets, the most profitable traders are likely to be those that are best fit to the latest cycle. This does not happen too often with dentists or pianists – because of the nature of randomness. (p.74)

The easy way to see this is that in boom times, the highest returns often go to those who take the most risk. That doesn't say anything about their being the best investors.

Warren Buffett's appendix to the fourth revised edition of "The Intelligent Investor" describes a contest in which each of the 225 million Americans starts with $1 and flips a coin once a day. The people who get it right on day one collect a dollar from those who were wrong and go on to flip again on day two, and so forth. Ten days later, 220,000 people have called it right ten times in a row and won $1,000. "They may try to be modest, but at cocktail parties they will occasionally admit to attractive members of the opposite sex what their technique is, and what marvelous insights they bring to the field of flipping." After another ten days, we're down to 215 survivors who've been right 20 times in a row and have won $1 million. They write books on "How I Turned a Dollar into a Million in Twenty Days Working Thirty Seconds a Morning" and sell tickets to seminars. Sound familiar?

Thus randomness contributes to (or wrecks) investment records to a degree that few people appreciate fully. As a result, the dangers that lurk in thus-far-successful strategies often are under-rated.

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)

Perhaps a good way to sum up Taleb's views is by excerpting from a table found on page 3 of his book. He lists in the first column a number of things that easily can be mistaken for

Randomness	Determinism
Probability	Certainty
Belief, conjecture	Knowledge, certitude
Theory	Reality
Anecdote, coincidence	Causality, law
Survivorship bias	Market outperformance
Lucky idiot	Skilled investor

The table reminds me of a key difference between the "I know" and "I don't know" schools. "I don't know" investors are acutely conscious of the things in the first column; "I know" investors routinely mistake them for things in the second.

I think Taleb's dichotomization is sheer brilliance. We all know that when things go right, luck looks like skill. Coincidence looks like causality. A "lucky idiot" looks like a skilled investor. Of course, knowing that randomness can have this effect doesn't make it easy to distinguish between lucky investors and skillful investors. But we must keep trying.

I find that I agree with essentially all of Taleb's important points.

Investors are right (and wrong) all the time for the "wrong reason." Someone buys a stock because he expects a certain development; it doesn't occur; the market takes the stock up anyway; he looks good (and invariably accepts credit).

The correctness of a decision can't be judged from the outcome. Nevertheless, that's how people assess them. A good decision is one that's optimal at the time it's made, when the

future is by definition unknown. **Thus correct decisions are often unsuccessful, and vice versa.**

Randomness alone can produce just about any outcome in the short run. The effect of random events is analogous to the contribution from beta discussed on page six. In portfolios that are allowed to reflect them fully, market movements can easily swamp the skillfulness of the manager (or lack thereof). But certainly market movements cannot be credited to the manager (unless he's the rare timer who's capable of getting it right repeatedly).

For these reasons, investors often receive credit they don't deserve. One good coup can be enough to build a reputation, but clearly a coup can arise out of randomness alone. Few of these "geniuses" are right more than once or twice in a row.

Thus it's essential to have a large number of observations – lots of years of data –

LUCK VS SKILL: DECEMBER, 2006

Above average investment performance (in any market) has to be the result of either unusual insight into values or the intersection of risk taking and luck. It's hard to tell the difference between the two in the short run, but the truth always becomes clear in time, because luck rarely holds up for long

ALTERNATIVE HISTORY: DECEMBER, 2006

To be able to attach the proper significance to short-run performance, it's essential that one understand the idea of "alternative histories." I came across it in Taleb's book, which I consider the bible on such topics. This concept is related to Orin Kramer's description of Tpast performance as "the interaction of particular historical and market conditions and the judgments and beliefs of managers during that period." **In other words, investment performance is what happens to a portfolio when events unfold.** People pay great heed to the resulting performance, but the questions they should ask are, "Were the events that unfolded (and the other possibilities that didn't unfold) truly within the ken of the portfolio manager? **And what would the performance have been if other events had occurred instead?" Those other events are Taleb's alternative histories."**

You can't judge the correctness of a decision from the outcome. This is another concept that many people find nonsensical. But good decisions fail to work all the time – just as bad ones lead to success – simply because it's so hard to predict which history will materialize.

COMPLEXITY IN RISK ASSESSMENT (JANUARY – 2006)

It is my purpose in this section to highlight a few reasons why risk assessment is not simply a matter of one number (as implied by the attention paid to volatility), but multi-dimensional

instead. Rick Funston of Deloitte pointed out in our board briefing materials that risk assessment requires us to deal with four complicating factors:

- **Scenarios**
- **Offsets**
- **Correlations**
- **Domino effects**

By “scenarios,” Rick refers to alternative or abnormal future scenarios that go beyond the normal range of outcomes – in his words, “the possible but unusual.”

“Offsets” translate in the investment world into something very familiar: diversification. Intelligent diversification means not just investing in a bunch of different things, but in things that respond differently to the same factors. In a well-diversified portfolio, something that negatively influences investment A might have a positive and offsetting influence on investment B.

“Correlations” are somewhat the opposite. The term refers to the chance that a number of investments will respond in the same way to a given factor. Be alert, however, to the fact that when things in the environment turn really negative, seemingly unconnected investments can be similarly affected. “In times of panic,” they say, “all correlations go to one.”

Finally, “domino effects” refer to the likelihood that a given factor will cause trouble for investment A, which will be a problem for investment B, which will hurt investment C, and so on. Obviously, domino effects can result in combinations that are bigger than any one issue alone and quite hard to anticipate.

Clearly, because of these factors among so many others, risk can’t be reduced to a single number or handled simplistically. Because of its multi-dimensional nature, it can only be dealt with by skilled and experienced individuals making judgments that are by their nature subjective. And even those individuals must always be conscious of how much they don’t know.

When the emerging markets melted down in 1998, accompanied by the collapse of Long Term Capital Management and the crisis in Russia, most investors thought their risk was limited to their holdings of emerging market securities. But they soon saw firsthand the ability to be affected through the stocks of U.S. companies doing business in emerging markets, high yield bond funds that had dabbled in sovereign debt, and private equity investments exposed to the economies in question.

Fault lines run through every portfolio, adding to the complexity of managing risk. It’s hard to anticipate all of them, but trying to do so lies at the heart of effective risk management.

CREDIT CRISIS

HOW THEY FORGOT EASILY (MAY 2010)

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.

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.

DIVERSIFICATION VS CONCENTRATION

DIVERSIFICATION – SEPTEMBER, 2006

Over-diversifying – It's common for portfolios to have rules stating that they can't invest more than x% per manager or per fund. However, it's probably only on rare occasions that they approach those limits. In my opinion, most portfolios are spread too thin. **While it's true that only large positions can get you into trouble, it's equally true that only large positions can make a big contribution. (This is one of the great dilemmas in investing.)**

When I see 1% or ½% of portfolio capital invested with a trusted (and diversified) fund or manager, it strikes me as too little. A manager who has earned his clients' confidence should be entrusted with enough money to make a difference in overall portfolio results. One pension plan was bold enough to let Oaktree manage 70% of its alternatives portfolio, and this led to a relationship that was wildly successful for both sides. How many investors would have taken that chance?

When you're dealing with investments where reliable probabilities can't be assigned to the possible outcomes, or which entail the possibility of significant risk to the corpus (make-it-or break- it-type risks), failing to diversify can be a big mistake. But when you know of managers and strategies that appear to offer high returns with bearable, controlled risks, and when reasonable judgments can be made about the probable outcomes, it's failing to concentrate that can be the big mistake.

In short, if you can get money to work with people that your experience shows you can rely on, load up!

DARE TO GREAT – SEPTEMBER – 2006

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?**

I learned a lot from my favorite fortune cookie: **The cautious seldom err or write great poetry.** It cuts two ways, which makes it thought-provoking. Caution can help us avoid mistakes, but it can also keep us from great accomplishments.

Personally, I like caution in money managers. I believe that in many cases, the avoidance of losses and terrible years is more easily achieved than repeated greatness, and thus risk control is more likely to create a solid foundation for a superior long-term track record. Investing scared, requiring good value and a substantial margin for error, and being conscious of what you don't know and can't control are hallmarks of the best investors I know.

But in assembling a portfolio of managers and strategies, there has to be an element of boldness if you hope to enjoy superior returns. Too large a dose of caution in asset allocation can keep portfolios from outperforming the norm.

Two additional factors bear on the integration of risk management in asset allocation, with its pivotal role in portfolio construction:

First, as Professor William Sharpe demonstrated, adding a risky strategy to a portfolio with which it is uncorrelated can reduce the overall riskiness of the portfolio.

Second, it should be borne in mind that when one portfolio places a greater emphasis than another on managers who lean toward risk control, that portfolio can allocate more of its capital to risky strategies without having a higher overall quantum of risk. Thus, while restricting your total risk to your targeted level, **would you rather allocate more money to the aggressive asset classes via risk-controlling managers, or less money with freewheeling managers?**

DIVERSIFICATION AND LEVERAGE – DECEMBER, 2006

Diversification has long been considered a pillar of conservative investing. It's a simple concept: "Don't put all your eggs in one basket." Spreading your capital among a number of assets or strategies reduces the likelihood of a disaster. **Diversifying into uncorrelated assets with borrowed money can increase, not reduce, the risk of the portfolio. It's essential to remember that leverage is the ultimate two-edged sword: it doesn't alter the**

probability of being right or wrong; it just magnifies the consequences of both. Diversification is a good thing, but a lot depends on how you finance it.

DI-WORST-IFICATION AND LEVERAGE – SEPTEMBER 2007

Warren Buffett harps on the folly of branching out into things you know less about solely for the purpose of increasing the number of baskets in which you have your eggs. Investing in things about which you aren't expert doesn't reduce risk, it increases it. And I think it's particularly unwise to finance diversification with

DIVERSIFICATION AND CO-RELATION – DECEMBER 2006

Underestimating correlation. There's another old saying: "In times of crisis, all correlations go to one." It means that assets with no fundamental or economic connection can be caused by market conditions to move in lockstep. If a hedge fund experiences heavy withdrawals during a period of illiquidity, assets of various types may have to be dumped at once, and thus they can all decline together. Further, hidden fault lines in portfolios can produce unexpected co-movement. Let's say you're long sugar and gas, two unrelated commodities. Unusually warm weather can reduce the demand for gas for heating and also cause a record sugar crop (as happened this year). Thus the prices of seemingly unrelated goods can decline together. Intelligent diversification doesn't mean just owning different things; it means owning things that will respond differently to a given set of environmental factors. Thus it requires a thorough understanding of potential

DIFFICULT TO VALUE – PRECIOUS METALS, OIL AND CURRENCIES OR ONLY CASH FLOW PRODUCING ASSETS CAN BE VALUED – DECEMBER 2006

I want to say up front that I have absolutely no idea how one dependably achieves above average profits from trading or investing in commodities, precious metals or currencies. That's not to say it can't be done. There are people who've gotten very rich that way, managing both their own money and that of others.

Of course, the efficient market crowd would say someone will get rich doing everything – even playing the lottery or flipping coins – simply because the tails of a probability distribution usually aren't entirely unpopulated. **But who it is that gets rich that way may be purely random. If that's the case, the mere existence of a few winners doesn't in itself prove that something is an "alpha" activity in which hard work and skill will produce consistent performance, or that large numbers of people can pull it off.**

I believe firmly that the markets for commodities and currencies are generally efficient. That means a lot of highly motivated people participate; many are intelligent and computer-literate; they all have access to similar information; and they're willing to take either side of most propositions.

If it's so hard to value currencies, commodities and precious metals, why do I think we can invest intelligently in equities, corporate debt and whole companies? It's because these things generate income, and an expected stream of future income can be translated into a current value. But how do you determine the intrinsic value of a Euro, a bar of gold or a barrel of oil? You can talk about the positives and the negatives associated with these goods. But how do you convert those things into a price?

For example, the factors that argue for high oil prices are obvious. "The supply is finite." "We're using it up at an accelerating rate." "Environmental issues in the U.S. will constrain the domestic supply." "Much of the foreign supply is in the hands of hostile or unpredictable governments: Iran's a worry, Venezuela is turning anti-American, and Saudi Arabia is subject to instability." Sure they make oil a valuable good, but how valuable? How do we know the current price doesn't adequately reflect these things already? What's the right price for it.

VALUING REAL ESTATE AGAIN IS DIFFICULT, IF NOT IMPOSSIBLE – DECEMBER – 2008

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.

REAL ESTATE (JANUARY, 2010)

> 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.

Capital Reserved 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.

GOLD HOLD VALUE ONLY BECAUSE PEOPLE AGREE THEY WILL - DEC 2010

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

Show me a company, security or property that produces a stream of cash and I think I can value it reasonably accurately. PE ratios, yields and capitalizations rates gives 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 is no analytical way in my opinion to value an asset that doesn't produce cash flow and especially that does not have any prospect of doing so.

All non-income producing asset are worth only what the buyer is willing to pay. That's true even for income producing asset but over long term, income producing asset value tend to move towards its intrinsic value. They may not move in any particular timeframe, but expectation provides solid base for investing.

The point I, 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 five rise to and the relationship of price to that value. And there is no quantifiable value against which to compare price in the case of gold. Either you agree with those statements or you don't.

Gold serve as a store of value because people agree it will. The main question is whether people faith in gold will increase or erode. Its hard to predict change in these things, but it's the change that makes and eliminates fortunes.

GENERAL IDEAS

I WRITE FEW ORIGINAL IDEAS

Before doing so, however, I must point out a few things: First, as usual, little that I will write will be original; instead, I hope to add value by pulling together ideas

from a number of sources. Second, a single word suffices to describe my recent caution regarding the stock market: wrong.

My memos are full of quotations, adages and old saws. I'm attached to a few and tend to use them over and over. Why reinvent the wheel, especially if the old one can't be improved upon? Hopefully the things I borrow contain enough wisdom to make them worth repeating.

INFLATION (JANUARY, 2010)

- Power of labourers to demand strong wage increases or cost of living adjustments
- Strong inflation is usually associated with higher levels of prosperity and stronger demand for goods.
- Finally, inflation often presupposes pricing power on the part of manufacturers.
- Increase in import cost either due to currency depreciation or surge in international commodity prices.

  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.

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.

Those who cannot remember the past are condemned to repeat it. - philosopher Santayana

DEMOCRATIZATION OF INVESTMENTS HAS DONE MORE HARM THAN GOOD (JULY- 2009)

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.)

ECONOMICS ISN'T AN EXACT SCIENCE (MARCH, 2009)

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. **All** 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.**

RECESSION DOES NOT MATTER, SLUGGISH GROWTH MATTERS MORE – JANUARY, 2008

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.**

MARKET EFFICIENCY

The market may often misvalue stocks, but it's not easy for anyone person - working with the same information as everyone else and subject to the same psychological influences - to consistently know when and in which direction. That's what makes the mainstream stock market awfully hard to beat - even if it isn't always right.

GOOD QUOTES

- We always read "I think the stock market's going to go up." We never read "I think the stock market's going to go up, (and 8 out of my last 30 predictions were right)" or "I think the stock market's going to go up (and by the way I said the same thing last year and was wrong)." Can you imagine deciding which baseball players to hire without knowing their batting averages? When did you ever see a market forecaster's track record?

- Markets run on Fear or greed: It is often said that the market runs on fear and greed, but I believe it usually runs on fear or greed; that is, at most points in time, one or the other predominates.

- “Markets often do things that defy logical explanation – but people keep explaining them anyway”

- Every day we hear or read that “the market rose on hopes that . . .” or “. . . because investors were cheered by the news that . . .” Or perhaps it’s “the market fell on fears that . . .” or “. . . because of negative reaction to . . .” How do the commentators know? Where do they look to learn the reason for each day’s move? Does there have to be an explanation? Why don’t we ever hear, “The market rose today, but no one knows why”?!

- I think statistics are like matches – the unsophisticated shouldn’t play with them. When shown to the public, they tend to produce confusion between possibility, probability and a sure thing, and between random occurrence and cause-and-effect. (March, 2003)

- I’d rather see them talk about what you can’t know than what you can. In other words, don’t give investors new forecasts that they’ll count on to lead them to sure profits. Tell them there’s no such thing. That would be a public service! (March, 2003)

- There’s no reason in the world you should expect some broker to tell you whether you can make money on index futures or options or some stock in two months. If he knew how to do that, he wouldn’t be talking to investors. He’d have retired long ago – Warren Buffet

- Management, Reserved Overestimating what you’re capable of knowing or doing can be extremely dangerous – in brain surgery, cross-ocean racing or investing. As Dirty Harry said, “A man should know his limitations.” Acknowledging the boundaries of what you can know – and working within those limits rather than venturing beyond – can give you a great advantage. (March, 2003)

- Brevity of the financial memory
  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.
  . . . 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, Viking, 1990

- In Vegas they say, "the more you bet, the more you win when you win." Although the logic of this statement is impeccable, it omits the obvious addendum ". . . and the more you lose when you lose." Leverage is not a source of alpha; it's a way of increasing your exposure to a given amount of alpha . . . or lack of alpha.

  "The farther backward you can look, the farther forward you can see." – Winston Churchill

  - As a general rule, it is foolish to do just what other people are doing, because there are almost sure to be too many people doing the same thing.

  - There is no investment idea so good that it can't be ruined by a too high entry price. And there are few things that can't be attractive investments if bought at a low-enough price.

  - "It can only go up" and "if it stops working, I'll get out" – two phrases that are heard in the course of virtually every financial mania – proved once again to be highly flawed. To avoid the trap in residential real estate, one needed a memory of events that occurred more than ten years earlier, the ability to understand their implications, and the discipline to resist joining the herd.

  - No matter how favorable and steady fundamentals may be, the markets will always be subject to substantial cyclical fluctuation. UThe reason is simple: even ideal conditions can become overrated and therefore overpriced.U And having reached too-high levels, prices will correct, bringing capital losses despite the idealness of the environment (see tech stocks in 2000). So don't fall into the trap of thinking that good fundamentals = positive market outlook (and especially not forever).

  - It ain't what you don't know that gets you into trouble. It's what you know for sure that just isn't so - Mark Twain
  - Ensuring the protection of capital under adverse circumstances is incompatible with maximizing returns in good times, and thus investors must choose between the two. That's the real lesson – September, 2007
  - These things (On recovery from worst case 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.
  - **Our knowledge is limited to the parts we've touched:** 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

- "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, James Grant)
- Few investors recognize 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. (January, 2009)
- 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.
- Not everything that can be counted counts, and not everything that counts can be counted – Albert Einstein.
- 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."
- Ronald Reagan said of arms treaties, "Trust, then verify."
- 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.
- 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." - Irving Fisher, writing 76 years ago ("The Debt-Deflation Theory of Great Depressions," *Econometrica*, March 1933
- "History doesn't repeat itself, but it does rhyme." – Mark Twain
- What the wise man does in the beginning, the fool does in the end."
- Portfolio construction is supposed to strike an appropriate balance between safety and certainty on one hand and aggressiveness and gains-seeking on the other – Sept 2010
- Charlie Munger once said about investing, "It's not supposed to be easy. Anyone who finds it easy is stupid."
-

MANAGEMENT

And encouraging moral behavior, perhaps above all else, is the responsibility of top management. One thing I'm convinced of is that you can't have a great organization without someone at the top setting the tone. The Chairman and CEO can't know everything that goes on in a company, can't be conversant with the details and merits of every transaction, and can't participate in any but the most senior hires. **But they can create a climate where expectations are high and the emphasis is on means, not just ends**. **I believe many investors underestimate the difficulty of investing, the importance of caution and risk aversion, and the need for their active, skeptical involvement in the process**. *Caveat emptor*. Or as they say on TV, "don't try this at home."

FRAUDULENT MANAGEMENT

They invested with managers who were the subject of complaints and lawsuits alleging improper conduct; these things can be checked out but apparently weren't. It seems investors took comfort from the fact that the brokerage affiliate was licensed by the NASD. What they missed, however, was the fact that the NASD would police the conduct of the brokerage arm but not the fund or its management.

SPECIAL SITUATION OR RISK ARBITRAGE:

So if stocks are poised for unexciting single-digit returns, (and if the period ahead may be marked by more negative surprises than the recent past, which I believe), what looks promising? I suggest you search for returns that are not predicated on market advances. Lastly, I would take a good look at "absolute return-type" strategies. These are designed to systematically take advantage of market inefficiencies and to capture managers' alpha while limiting susceptibility to fluctuations. Arbitrage, long/short, hedge and market-neutral strategies fall into this category. Most strive to earn returns in the teens on a consistent basis, with relative indifference to the performance of the mainstream markets.

SPECIAL SITUATIONS

The returns available from an investment strategy are not independent of the amount of money seeking to be deployed in that strategy. More simply put: everything else being equal, more money means lower returns. This seems elementary, but it appears to be ignored every time something does well for a while. I repeat for the umpteenth time: what the wise man does in the beginning, the fool does in the end. (June, 2006 – in regard to discussion of convertible artbitrage).

SPECIAL SITUATION WITH LEVERAGE ARE LIKE PICKING NICKLES – DECEMBER, 2006

One of Long-Term's principals had said, **"We're going around the world scooping up nickels and dimes."** There's great appeal to his notion of profiting from a large number of small mispricings that others aren't smart enough to seize upon. But he had left off a few key words from the end of his sentence: **". . . in front of a steamroller."** The steamroller enters the picture when so much leverage is employed that a fund can't survive a moment of aberrant market behavior.

GROWTH VS VALUE INVESTORS (2002-11)

"Growth investors" pursue companies whose earnings are growing the fastest. As per the equation, if the P/E ratio holds, earnings growth will be translated directly into stock price appreciation. And if there's an increase in investor recognition of the company's growth

potential, the P/E ratio can expand as well, producing appreciation at a rate that exceeds the rate of earnings growth.

"Value investors," on the other hand, invest primarily in companies where (1) earnings, while perhaps lacking rapid trendline growth potential, are temporarily depressed and likely to rebound, and/or (2) the stock's price is unduly low relative to even the low-growth earnings, and thus the P/E ratio can be expected to expand.

SOURCES OF RETURNS (2002-11)

- Increases in an asset's intrinsic value (earnings or asset values),
- Movement of the asset's price from a discount toward its intrinsic value (that is, from undervaluation to fair value), and/or
- Movement of the price from intrinsic value toward a premium (that is, from fair value to overvaluation).

In my opinion, superior returns come most dependably from buying things for less than they're worth and benefiting from the movement of price from discount to fair value. Making money this way doesn't require increases in intrinsic value, which are uncertain, or the attainment of prices above intrinsic value, which is irrational.

The attractiveness of buying something for less than it's worth makes eminent sense. However, doing so requires cooperation from someone who's willing to sell it for less than it's worth. It's the SEC's goal to make sure that everyone has the same corporate information. So how is one to find bargains in efficient markets? You must bring exceptional analytical ability, insight or foresight. But because it's exceptional, few people have it. Once in a while someone will find an undervalued stock or guess right about the direction of the market, but very few people are able to do those things consistently over time.

In inefficient markets, not everyone has the same access to information. I feel bargains are found most consistently among the things that are not widely known, not understood, or considered to be risky, complex, unfashionable, controversial, or unseemly. When you combine unequal access to information, uneven ability to analyze that information, and the effects of negative biases, it's possible for things to sell for less than they're worth. In inefficient markets, it's possible for a superior investor to consistently identify those bargains, and thus to beat the other players consistently. It's also possible to achieve risk-adjusted returns above those available in other market niches. All it takes is hard work and superior skill.

Nothing can be relied on for high risk-adjusted returns just because of what it's called. No investment area has that birthright. It's all a matter of the ability to identify bargain-priced opportunities and implement with skill.

THE CAT, THE TREE, THE CARROT AND THE STICK (MAY, 2003)

(Investing in high risk equities to chase returns, when PE multiples were high and Debt yield in low single digit)

I hope you'll forgive an incredible mixing of metaphors, but I can't resist using one to sum up on the subject of the current investment environment. As I think about situations like today's, (which, by the way, is not unprecedented), I visualize a cat in a tree. A carrot lures him out onto increasingly higher branches, and a stick prods him from behind.

In my analogy, the cat is an investor, whose job it is to cope with the investment environment, of which the tree is part. **The carrot – the incentive to accept increased risk – comes from the high returns seemingly available from riskier investments. And the stick – the motivation to forsake safety – comes from the modest level of prospective return being offered on safer investments.**

The carrot lures the cat to higher branches – riskier strategies – in pursuit of his dinner (his targeted return), and the stick prods the cat up the tree, because he can't get dinner while keeping his feet firmly on the ground. And that's a pretty good description of today's investment environment.

RELATED PARTY TRANSACTIONS (MARCH, 2004):

"All these deals present the risk of conflicts between a company official's two roles: representative of the shareholder and individual seeking to get the best deal for himself."

- Are these deals negotiated at arm's length? Are the terms the best the company can get?
- Who negotiates on behalf of the shareholders? How vehemently?
- Where a deal is proposed by a shareholder or shareholder/director with a dominant ownership position, who stands up for the minority shareholders?
- How can we be sure director A won't simply vote for director B's excessive deal in exchange for director B returning the favor?
- As I mentioned above, there has been no allegation – even in Enron, Tyco and Adelphia – of actual director impropriety. Rather, the questions surround the energy put into governance.
- After working together for many years, directors develop congenial relationships with each other and with the executives. How strongly will they then fight to resist questionable transactions between the company and their colleagues?

- Directors’ fees can run into the hundreds of thousands, perhaps with stock options and perks in addition. Will a director risk this package to fight for some faceless shareholders?
- In short, can a director who serves at the pleasure of the chairman police the chairman and his other handpicked directors and executives? How can directors be guaranteed the independence that shareholders need to have them

As you prepare your estate plan, you count on fiduciaries – lawyers, accountants, executors and trustees – to ensure that your assets will be disposed of as you intend. Would you want one of those fiduciaries to buy assets directly from your estate? Rent office space to your estate? Employ his relatives to serve your estate, for additional fees? Enter into a joint venture with the company you left behind? You’d expect the stewards of your estate to be “purer than Caesar’s wife.” **Even with motivations that are entirely honorable, it would be impossible for your fiduciaries to simultaneously represent themselves and your heirs on opposite sides of a transaction and still maintain both the fact and the appearance of fairness**. Thus they must content themselves with the compensation they’ve been assigned by you or by law. They must resist the temptation to do business with your estate in a way that could benefit them further . . . and to possibly move a little from your heirs’ pockets to their own. We must expect no less from the stewards that we and our companies do business with every day

To put it more simply, we assume everything we do will show up on “page one” some day – that nothing will remain a secret. Will there be a negative reaction? Will anyone object?

HOW TO IMPROVE GROUP THINKING OR COMMITTEE MEETINGS

I think the key to successful committee efforts lies in “sparks.” There should be intellectual friction capable of generating heat and light: spirited discussion leading to unique insight. Professor Janis urges the leader to create an atmosphere that fosters “intellectual suspicion amidst personal trust.” Barton Biggs suggests praising those who disagree with the trend; designating devil’s advocates; and holding second-chance meetings where members can take another, skeptical look at decisions the group has made. He says, **“harmonious, happy meetings may be a warning of groupthink and complacency, whereas agitation, passionate arguments and some stress are good signs.”** While these latter things are no guarantee of correct, unconventional decisions, such decisions may prove elusive without them.

INCENTIVES – SEPTEMBER, 2006

Another way to address the issue is through incentives, to which creative principals should pay a lot of attention. An experienced director told Forbes in the early 1990s, “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.” To the extent possible, people involved in the investment process should be able to look forward to

rewards for attempts at nonconformity, not just penalties for decisions that don't work. That might be the best response to John Maynard Keynes's observation: "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

INSIST ON USING CONSULTANTS CONSTRUCTIVELY - SEPTEMBER, 2006

Consultants are what you make of them. They can bring expertise and data that only the largest of institutional investors can build internally. They can introduce ideas they're seeing in use elsewhere. They can support investors' efforts to innovate while making sure they don't go so far as to endanger the corpus. Because few institutions can afford to home-grow all of the resources that a good consultant has, consultants truly can be additive.

Or, they can just be used as a source of cover. Their stamp of approval can be sought as protection against potential criticism. They can be used to ensure that the portfolio is never different enough from the herd to stand out. They can be hired – and motivated – to preclude
innovation. Frighteningly, a consultant once told me, "I never initiate; if I did, I could be criticized for being wrong. I just opine when asked."

By supplying new ideas and needed data in support of an effort to be great, consultants clearly can add value. But left in bureaucratic mode, it is possible for them to contribute nothing other than protection. The choice – of consultant and *modus operandi* – is up to the client.

FOREST FIRE AND MORAL HAZARD CREATED BY FED

> "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".
> (Source: the *Los Angeles Times)*

Clearly, the analogy between financial crises and forest fires is solid. 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.

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.

THEM	US
"I know"	"I don't know"
Bullish by nature	Bearish by nature
Aggressive	Defensive
Confident	Guarded
Comfortable with risk	Obsessed with risk
What might go right?	What might go wrong?
Worried about winners missed	Worried about losers bought
Trend followers	Contrarians
Attracted to pretty flowers	Glad to search among the weeds
Comfortable when part of the crowd	Happy when apart from the crowd
Growth/momentum investors	Value investors
"Great things cost a lot"	Insistent on buying cheap
Believers	Skeptics
"We're in a new era"	"Trees don't grow to the sky"
Cheered by appreciation	Frightened by excessive appreciation
Enjoy averaging up	Enjoy averaging down
"Let it ride"	Eager to take profits
Relative return-oriented	Absolute return-oriented
Worried about underperforming	Worried about losing money
Pained by cash	Comfortable with cash
Confident in their powers	Aware that much is beyond their control
Convinced that their good returns are fully deserved	Highly conscious of the role played by luck
Impatient	Patient
Short term-fixated	Long term-oriented
Never worried by large amounts of capital	Aware that it's possible to have too much capital
Engrossed in watching the market	Devoted to watching companies
"The market's efficient"	"The market's an ass"

Everything's okay:	Worries abound:
Economic recovery underway	Movement of jobs overseas
Corporate profit gains	Gaping trade deficit
Increases in productivity	Growing budget deficit
Continuing foreign investment	Reliance on foreign capital
Ability of weak dollar to bolster exports	Threat to value of the dollar
Existence of job growth	Halting nature of job growth
Optimism implied by willingness to borrow	Consumers' high debt/low savings
Strong military capability	Risk of terrorism
Low level of interest rates	Risk of interest rate rise
Today's security prices are justified by low rates	Today's security prices are reliant on rates staying low

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YET TO BE CATEGORISED

What were they thinking (Oct, 2005)

The process of investing requires a strong dose of disbelief. Time and time again, the post mortems of financial debacles include two classic phrases:

It is my point that:

- Investors mustn't dwell excessively on recent experience.
- Instead, they must look to the future.
- They must consider today's developments critically.
- That assessment must take place in the light of history's lessons.

The value of hindsight lies in the fact that lessons learned in the past by others can enable subsequent generations to avoid having to learn them anew. And yet, it seems investors must learn those lessons over and over – and often the hard way. The exact circumstances may not repeat, and the mistakes may not surround the same asset classes, but the general lessons of investing go on having to be learned. To avoid this, we have to improve on the brevity of memory that Galbraith complains about; refuse to surrender our skepticism; and learn to assess market behavior around us and extract the proper inferences for application

Be careful when market ignore negative news in bull market (Oct, 2005)

When investors as a group are feeling upbeat, the market is able to shrug off negatives as isolated and insignificant. When they're depressed, investors generalize individual complications into an insurmountable web of negatives. I feel it's very important that we be aware of whether the market is giving events their proper weight, versus overlooking or overrating them. When things develop that should be considered, it's a matter of "Pay me now or pay me later

Investors are conservative if past results are poor and vice versa…(Oct, 2005)

Investors pursue safety when past results have been poor, but they lose interest in safety when past results have been good for a while. Not exactly contrarian, but the way it's always been. Investors have to learn that last year's return is not an indicator of next year's return, and thus of the appropriate strategy.

There can be no confusion between undervalued and overvalued

There can be lots of room for argument between “undervalued” and “fairly valued,” or between “fairly valued” and “overvalued” – that’s where most of the uncertainty lies. But it’s unlikely that disciplined investors will find it hard to choose between overvalued and undervalued. In my opinion, if you’re wracking your brain trying to figure out whether something’s overvalued or fairly valued – that is, whether you should sell or continue to hold – it’s usually pretty clear that it’s not a buy

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.

I’ll make a few suggestions below on what investors should and shouldn’t do. In the end, though, the things I suggest will be of little help without highly skilled implementation, and the results will depend almost entirely on that implementation and rather little on my suggestions.

Few people find high returns worrisome – December, 2006

In the investment business, clients love high returns and hate low returns. That makes sense. And when the market’s up 10% and their manager is up 20%, clients are really happy. But that’s my pet peeve. Rarely does anyone say, “Whoa. That return’s too high. How did it happen? How much risk did my manager take in order to generate that?” No, in the investment world few people find high returns worrisome.

Good quote – December 2006

It’s one thing to make an investment you know is risky and have it come out wrong. It’s something entirely different to make an investment that entails risk of which you’re unaware.

Experience is what you got when you didn’t get what you wanted.

Paper profits

All

Confusing paper profits with real gains.

The Wall Street Journal of September 20 points out that Hunter was encouraged by the positive marks to market showing up in his statements, so much so that he added further to his positions. But he seems not to have asked whether the gains were real and realizable. The Journal also points out that Hunter was such a big buyer in thin markets that his buying often supported prices and created the very profits he found so encouraging. But if the profits were the product of his buying, and thus dependent on it for their continued existence, he clearly had no way to realize them. My father used to tell a joke about the guy who insisted that his hamster was worth thousands more than he had paid for it. “Then you should sell it,” his friend urged. “Yeah,” he responded, “but to whom?”

Ignoring the impact of others. In small markets, everyone may know about your trades. That means they can copy them (making buying tough and adding to the crowd that will eventually jam the exits), and they can deny you fair prices if they know you have to sell. Aggressive traders, especially at hedge funds, don’t wear kid gloves.

Bad investors drive out good investors

But when usually disciplined bond buyers have to compete against others who aren’t acting in a disciplined fashion, their ability to insist on covenant protection goes out the window. In economics, Gresham’s Law says “bad money drives out good.” That’s why, when paper money joined gold as legal tender, gold was put in the strongbox rather than spent, and only paper money circulated. The same thing happens in the investing world: bad investors drive out good. When undisciplined investors are out there with lots of money to get rid of, there’s less scope for disciplined investors to insist on strong covenants. That’s why the level of covenant protection is a good barometer of the market climate.

The loners who buy from a crowd of dispirited sellers can get a good deal – and high returns –

because they’re few in number and early. But when every Tom, Dick and Harriet joins the herd,

after the merits of the situation have become obvious to all, they can't expect a bargain; the merits must be reflected fully – or to excess – in the price. In fact, each of those latecomers bears the risk of being the last to jump on the bandwagon . . . just before it goes off the cliff.

"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. The foregoing must be what Lord Keynes had in mind when he coined one of my favourite phrases: ". . . 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."

In 1978, triple-A bonds were considered respectable investments, while buying B-rated bonds was viewed as irresponsible speculation. Yet the latter have vastly outperformed the former, few of which remain triple-A today.

Elevated popular opinion, then, isn't just the source of low return potential, but also of high risk. Broad distrust, disregard and dismissal, on the other hand, can set the stage for high returns earned with low risk. This observation captures the essence of contrarianism.

Over its life, a bond that's bought at a 10% yield to maturity and doesn't default will return 10%, won't it? An obvious truth? No, actually something of a misstatement. The majority of the lifetime return on a long-term bond comes not from the promised interest payments and redemption at maturity, but from the interest earned on interest payments after they're received. The yield to maturity at which a bond is bought expresses the overall return

that will be earned if interest rates don't change – that is, if interest payments are reinvested at the rates prevailing at the time of purchase. But because interest rates are highly variable, so is the "interest on interest" component. Few non-bond people realize how un-fixed even fixed income investing is, and how substantial is the "reinvestment risk." And beyond bonds, it's even more up for grabs.

No matter how favorable and steady fundamentals may be, the markets will always be subject to substantial cyclical fluctuation. UThe reason is simple: even ideal conditions can become overrated and therefore overpriced.U And having reached too-high levels, prices will correct, bringing capital losses despite the idealness of the environment (see tech stocks in 2000). So don't fall into the trap of thinking that good fundamentals = positive market outlook (and especially not forever).