Memo to: Oaktree Clients

From: Howard Marks

Re: Now What?

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

<u>Boom</u>

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Bust

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

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

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

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

Anyway, here's how things went:

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

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

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

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

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

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

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

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

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

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

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

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

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

Clouds on the Horizon

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

Clearly things have just begun to be sorted out in the financial sector. Year-end pricing of mortgage-related securities may bring further writedowns. Auditors may view low prices as more defensible than high ones, and avoiding legal risk can influence their decisions. Conservative auditors will do battle with bank managements desirous of maintaining equity reserves and financial flexibility. On the other hand, there may be a

wish on the part of managements – especially new ones – to clear the decks by marking down or selling off problem assets. All of this may result in bigger losses in the short run.

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

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

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

Implications for the Broader Economy

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

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

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

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

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

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

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

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

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

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

The Fed's Dilemma

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

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

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

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

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

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

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

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

Averting Fire Sales

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

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

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

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

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

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

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

A Word on the Monoline Insurers

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

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

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

One or more of the insurers may need injections of equity capital to bolster their reserves. But what price will investors pay for their stock? (Warburg Pincus committed to invest

in MBIA about a month ago, when the stock was at $31, and today it's less than half that). And if the potential CDO losses are so great that a monoline insurer's net worth may be negative on an expected value basis, would anyone put in equity capital when the first of it basically will go to cover creditors? Certainly the monolines' future has been complicated by Warren Buffett's decision to compete by forming a new company that's not burdened by a CDO legacy.

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

The Shoe That Hasn't Dropped

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

January 10, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: Whodunit

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

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

The Subprime Factory

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

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

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

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

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

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

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

Turning Mortgage Loans into CDOs

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

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

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

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

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

But in the end, the rating agencies' greatest failing lay in giving their blessing to securities whose risk they couldn't accurately assess. The eventual default rate was crucial and unknowable. The historic data on subprime defaults related to mortgages that

were issued through a far different process and incentive system. But I can't imagine any agency saying, "The risks are unknowable; we just can't assign a rating."

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

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

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

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

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

All the participants in the CDO creation process took part in an activity we can call "ratings arbitrage." If you can take a bunch of assets with low ratings and – without adding to the intrinsic value of the collateral in any way – turn them into securities with

much higher average ratings, you can make a lot of money. But the ability to do so means there's something wrong. (In other words, if it's possible to start with 100 pounds of hamburger and end up selling ten pounds of dog food, 40 pounds of sirloin and 50 pounds of filet mignon, the truth-in-labeling rules can't be working.) **In the case of CDOs, ratings and insurance were supplied by parties who underestimated the risk, and the end product was sold – and bought – by people who were willing to participate in this purported miracle without asking the hard questions.**

The Failure of Risk Management

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

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

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

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

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

break.'" But in the end, subjective judgment was permitted to override risk management science, with great results.

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

Enough with the Quants Already

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

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

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

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

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

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

Greenspan and the Fed

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

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

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

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

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

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

In general, it seems the Fed – including the current Bernanke regime – wants to let advances run and limit declines, whether in the economy or the markets. Everyone wants

advances and no one – except bargain hunters and investors in distress – relishes pullbacks. But I wonder if that stance makes sense.

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

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

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

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

Kudos and Brickbats

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

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

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

Who else saw what was coming?

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

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

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

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

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

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

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

Where Does the Buck Stop?

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

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

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

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

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

part of CDO managers. I imagine they relied heavily on the participation of the rating agencies and monoline insurers. Each of these was flawed.

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

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

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

* * *

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

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

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

Far more participants in this process covered themselves with dishonor than with distinction, as attested to by the magnitude and ubiquitousness of the losses. But the

blame for the current problems falls primarily on two groups, and there's nothing new about either:

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

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

February 20, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Tide Goes Out

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

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

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

Leveraging and Inflating

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

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

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

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

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

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

Deleveraging and Deflating

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

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

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

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

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

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

Mark-to-Market Accounting

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

<u>"Should" ≠ "Will"</u>

Lately I've enjoyed comparisons of recent developments to Frankenstein's loss of control over his monster, or to a man-made mutation that has escaped from the laboratory. Extensive financial sector experimentation took place involving unprecedented combinations of volatile elements such as leverage, securitization, tranching, derivatives

and mark-to-market accounting. In the lab, experimental microbes would be quarantined until their dangers were fully understood. In the financial markets of this decade, on the other hand, they were rapidly popularized and peddled world-wide.

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

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

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

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

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

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

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

Leverage and Risk

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

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

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

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

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

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

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

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

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

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

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

<u>Financial Self-Destruction</u>

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

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

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

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

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

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

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

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

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

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

A New Kind of Crisis

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

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

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

The current bust arose against a backdrop of healthy fundamentals. The economy was growing. Commercial real estate wasn't overbuilt. Bond defaults were at record lows. Yet huge markdowns have taken place in these areas. Thus the solution will not come

from addressing localized fundamental problems. Instead, the problem is hydra-headed, affecting a large number of areas due to contagion. Larry Summers put it this way:

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

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

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

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

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

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

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

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

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

Where Will It End?

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

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

* * *

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

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

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

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

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

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

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

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

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

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

March 18, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Aviary

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

A Dead Duck

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

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

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

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

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

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

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

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

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

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

The Canard of Free Market Infallibility

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A New Canard Takes Flight

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

<u>The Black Swan</u>

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

The main thrust of *Fooled by Randomness* was that while many of the forces that shape investment performance – or history in general – are random in nature, people often ignore that fact and give them meaning that would be warranted only if they weren't random. Thus the top performing investor in a given year may be the manager – in Taleb's terminology, the "lucky

idiot" – who took an extreme and unwise position and was bailed out by a highly improbable event that occurred by chance. For that reason, one year of outstanding performance says absolutely nothing about the likelihood of another.

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

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

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

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

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

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

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

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

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

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

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

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

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

Birds on a Wire

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

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

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

- The **subprime crisis** resulted from trends that had been building during the preceding years: leverage, securitization and tranching, financial engineering, looser ratings, unregulated non-

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

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

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

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

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

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

Already, businesses are reporting declining or disappointing earnings (even General Electric). Unemployment is on the rise. Higher prices for oil and food are likely to cut into consumers' ability to spend. And their psyches have been damaged by scary headlines they may or may not

understand. Consumer confidence is at low levels, and fewer Americans expect an improving future. Much of the growth in consumer spending has been abetted by the more widespread availability of credit. Now, less credit should mean less spending. These aren't the conditions for a vibrant economy.

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

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

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

Phoenix from the Ashes?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

* * *

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

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

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

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

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

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

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

May 16, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: Doesn't Make Sense

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

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

<u>Letting the Market Call the Tune</u>

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

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

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

Compulsory Short-Termism

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

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

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

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

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

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

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

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

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

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

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

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

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

Unreliable Ratings

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

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

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

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

A Model Destined to Fail

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

<u>When It's Good to Be Bad</u>

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

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

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

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

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

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

<u>Blame the Speculators</u>

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Eliminating the Fear of Loss

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

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

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

Tom asked if I didn't see a parallel between the management of our financial system and the policy toward forest fires. The western states experience forest fires all the time, for

any number or reasons: lightning, stray cigarettes, campfires that get out of control, even arson. While undesirable, these frequent fires have a good side: they get rid of the relatively small amount of dry brush created each year during our dry season.

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

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

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

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

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

Counting on a "V"

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

July 31, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: What Worries Me

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

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

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

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

The American Century

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

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

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

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

In Praise of the Melting Pot

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

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

But today the outlook isn't the same:

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

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

comparable educational institutions of their own. That day seems far off – institutions like these don't arise in an instant – but it isn't an impossibility.

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

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

Standard of Living

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

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

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

The World's Highest Earners

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

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

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

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

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

What Do You Make?

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

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

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

Joe does Ed's legal work, and Ed keeps Joe's books. Sarah cuts Bob's hair, and Bob cooks in the restaurant where Sarah eats. Rich drives the bus that takes Sue to the bank,

and Sue handles Rich's loan application. And, of course, someone like me manages investments for all of them. But how does an economy function if nobody actually makes anything – and if we have to buy all of our stuff from other countries? I'm exaggerating for impact, but you get my meaning. We make less and less each year – and we consume more.

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

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

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

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

Earning and Spending

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

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

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

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

<u>Who Else?</u>

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

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

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

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

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

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

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

Affording Retirement

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

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

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

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

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

The Healthcare Dilemma

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

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

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

<u>Growing Inequality</u>

The capitalist system produces gains because of a Darwinian process in which participants are spurred on by economic incentives and the most successful enjoy great rewards. The system runs on the ability of those who are more talented and/or work

harder to do better than others. Inevitably the better life also goes to some who are undeserving and just lucky or born into wealth; that's undesirable but inescapable. But it's not good if the margin by which some do better than others is too big.

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

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

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

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

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

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

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

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

The Energy Problem

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

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

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

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

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

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

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

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

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

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

Who'll Own the World?

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

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

But sometimes we resent their presence. It doesn't take much for xenophobia to rear its ugly head. In the 1980s, there was fear that Japan's economic juggernaut would lead to a wholesale takeover of U.S. assets by Japanese buyers. A couple of years ago, proposed

investments by China and Dubai in our oil and port industries were rebuffed, and last fall (before it was clear how desperately we needed more capital), people were grumbling about sovereign wealth funds' growing influence over our financial institutions.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

* * *

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

Take the earlier discussion of oil prices. We know high prices discourage consumption and encourage conservation, fuel efficiency, exploration and the development of

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

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

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

* * *

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

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

August 28, 2008

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

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

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

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Memo to: Oaktree Clients

From: Howard Marks

Re: Nobody Knows

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

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

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

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

Boom-Bust

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

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

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

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

How Things Got This Way

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

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

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

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

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

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

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

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

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

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

Does the Market Know?

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

In some cases, the signal for increased worry comes from increases in the price of credit default swaps, which provide insurance against debt defaults. Rising CDS prices imply that creditors have become more concerned. This can send down the prices of a

company's stock and debt instruments and frighten customers and depositors into withdrawing funds, potentially leading to downgrading and failure. In other words, increases in prices for credit insurance can serve as self-fulfilling prophesies. This is the unintended consequence of one of the recent innovations.

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

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

The End of the Financial System

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

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

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

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

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

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

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

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

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

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

What Kind of Future Do We Face?

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

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

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

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

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

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

What Will Start the Recovery?

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

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

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

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

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

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

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

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

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

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

September 19, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: Plan B

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

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

<u>Ya' Gotta Believe</u>

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

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

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

I've described in the past how financial institutions are vulnerable to loss of faith because of their unique combination of opacity, leverage, conscious risk bearing, and their use of short-term deposits and borrowings to fund longer-term, illiquid assets. When providers of capital lose faith in a financial institution, they line up to withdraw their money. But the institution can't give them all back their money, because it can't liquify all of its assets immediately. Attempts to do so increase the downward

pressure on asset prices, further weakening financial positions and reinforcing the loss of faith. And thus the circle becomes vicious and we have a "run on the bank."

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

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

The Source of the Problem

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

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

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

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

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

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

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

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

Does Ben Know Something We Don't?

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

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

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

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

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

The Plan and the Stumbling Blocks

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Who's In the Wrong?

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

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

As a result of the recent market action, short selling was outlawed in roughly 800 financial stocks, including outliers such as General Electric. This action was coincident with last Friday's rally, and people breathed a sigh of relief. Had short sellers been

responsible for the demise of Lehman? Should short selling be banned? As usual, the answer isn't clear.

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

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

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

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

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

*   *   *

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

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

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

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

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

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

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

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

September 24, 2008

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

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

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

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Limits to Negativism

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

The Swing of Psychology

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

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

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

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

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

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

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

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

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

The Black Swan

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

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

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

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

The White Swan

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

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

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

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

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

The Future

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

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

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

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

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

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

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

mentioned in "Now What?" in January. We still have to see money begin to circulate throughout the system.

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

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

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

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

Awash in Money

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

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

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

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

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

Lord Keynes judged the situation this way:

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

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

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

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

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

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

The New Financial Order

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

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

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

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

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

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

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

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

*　　　*　　　*

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

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

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

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

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

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

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

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

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

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

October 15, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: Volatility + Leverage = Dynamite

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

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

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

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

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

The Problem at Financial Institutions

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

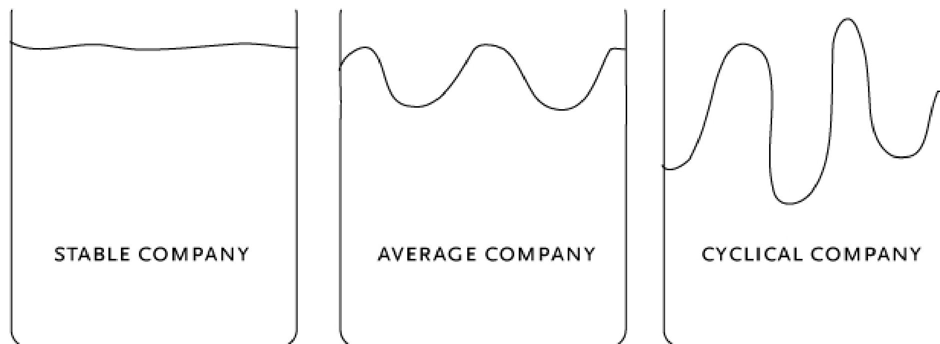
> This time around, assets are evidently so rotten in so many places that no financial institution wants to risk doing business with any other financial institution without a government backstop.

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

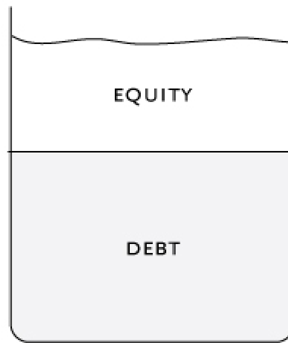
The Right Level of Leverage

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

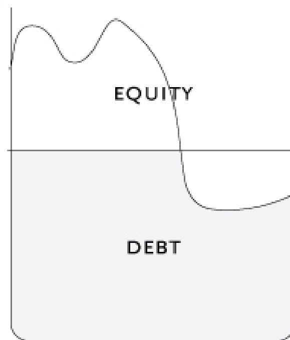
The drawings below show the value of companies of different types. Due to the variability of their earnings, the values fluctuate differently over time.



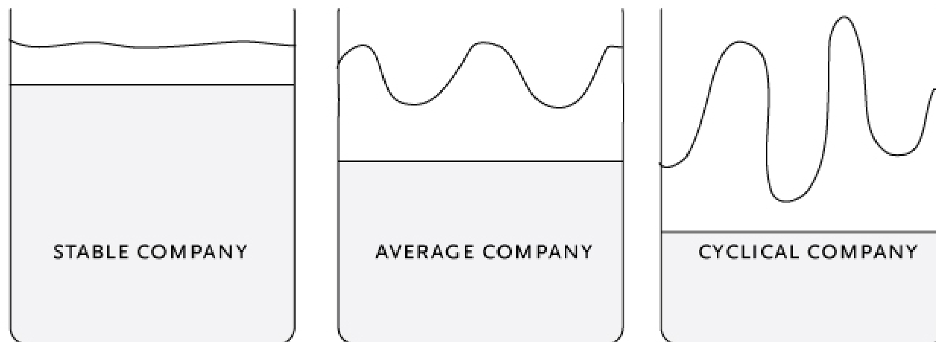
Here's a financial structure, except with the equity above the debt, not below as it would be on a balance sheet:



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



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



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

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

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

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

Why Mortgages?

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

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

What's a barrel of oil worth? $33 in January 2004, $147 in mid-2008, or $42 earlier this month? Which price was "right"? All of them? Or none of them? We all know about

the things that will influence the price of oil, such as finite supply, growing demand, and the unreliability of some of the producing nations. But what do those factors make it worth? **No one can convert these intangibles into a fair price.** That's why, a few months ago at $147, we were seeing predictions of $200 oil. And now, with the price down two-thirds, there's talk of $25.

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

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

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

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

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

The institutions' writedowns generally are in collateralized debt obligations (CDOs), debt issued by special-purpose entities that borrowed huge amounts relative to their equity in order to purchase mortgage-related securities. As described earlier, underestimated risk

led to the use of unwise amounts of leverage. But interestingly, the key losses aren't in the riskier junior tranches of CDO debt, about which there was some leeriness. Rather, they're in the triple-A-rated tranches. It's to buy those tranches that our leading institutions took on too much leverage. **Once again, greatly underestimated risk led to great leverage and thus great losses.**

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

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

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

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

How Bad is Bad?

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

The example in the paragraph on page one demonstrates the role of risk in the equation. The more your assets are prone to permanent loss, the less leverage you should employ. But it's also important to recognize the role of volatility. Even if losses aren't permanent, a downward fluctuation can bring risk of ruin if a portfolio is highly leveraged and (a) the

lenders can cut off credit, (b) investors can be frightened into withdrawing their equity, or (c) the violation of regulatory or contractual standards can trigger forced selling.

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

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

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

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

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

Consider these tales from the front lines:

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

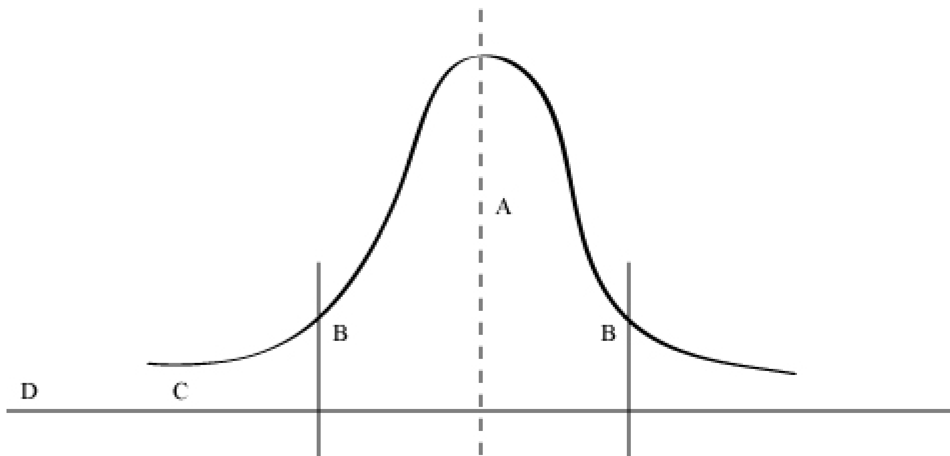
- In my twenty-nine previous years with high yield bonds, including four when more than 10% of all outstanding bonds defaulted, the index's worst yearly decline was 7%. But in 2008, it's down 30% (even though the last-twelve-months' default rate is only about 3%).

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

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

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

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



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

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

Are You Tall Enough to Use Leverage?

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

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

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

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

* * *

I never want to give the impression that doing the things I discuss is easy, or that Oaktree always gets it right. This memo calls on investors to gauge risk and use only appropriate leverage. At Oaktree we assess fundamental riskiness and look to history for how markets might behave, and we heavily emphasize trying to build in sufficient room for

error. But history isn't a perfect guide. While we've made no use of leverage in the vast majority of our investment activities, three of our evergreen funds did borrow to buy bank loans: the senior-most debt of companies, which in the past always has traded around par. Another used it to buy low-priced Japanese small-cap stocks. The companies generally are doing fine, but the prices of their loans and equities have collapsed under current market conditions, causing the funds to suffer. **This shows how tough it is to prepare for all eventualities . . . in other words, to know in advance how bad is bad**. So I apologize if I ever come across as holier-than-thou. We've tried to use leverage only when it's wise, but no one's perfect. Certainly not us.

* * *

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

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

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

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

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

December 17, 2008

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Memo to: Oaktree Clients

From: Howard Marks

Re: The Long View

Many of my memos over the last year and a half have touched on the developments in 2003-07 that brought on the current financial crisis. By now, everyone understands the role of innovation, risk tolerance and leverage in the boom that led to the bust, so I think it's now time to look back considerably further.

The Importance of Cycles

In my opinion, there are two key concepts that investors must master: value and cycles. For each asset you're considering, you must have a strongly held view of its intrinsic value. When its price is below that value, it's generally a buy. When its price is higher, it's a sell. In a nutshell, that's value investing.

But values aren't fixed; they move in response to changes in the economic environment. Thus, cyclical considerations influence an asset's current value. Value depends on earnings, for example, and earnings are shaped by the economic cycle and the price being charged for liquidity.

Further, security prices are greatly affected by investor behavior; thus we can be aided in investing safely by understanding where we stand in terms of the market cycle. What's going on in terms of investor psychology, and how does it tell us to act in the short run? We want to buy when prices seem attractive. But if investors are giddy and optimism is rampant, we have to consider whether a better buying opportunity mightn't come along later.

The Lessons – and Limits – of Experience

I feel good about having been aware of where we stood in terms of the market cycle and investor behavior over the last four or five years. There were memos that talked about low prospective returns and meager risk premiums ("Risk and Return Today," October 2004), repetition of past mistakes ("There They Go Again," May 2005), investor inattention to warning signs ("Hindsight First, Please," October 2005), and the rising willingness to accept lower returns and less safety ("The Race to the Bottom," February 2007). Importantly, these views were factored into Oaktree's actions, enabling us to make some good decisions on behalf of our clients.

I recite these successes not for the purpose of self-congratulation, but to point out that while I was highly aware of the short-term cycle, I – like almost everyone else, it seems – failed to fully appreciate the big-picture peril implied by the level to which the cycle had risen. In short, I thought 2003-07 was like the other cycles I've lived through, just more so. I missed the fact that it was different not only in degree, but also in kind.

This episode is different because over the preceding decades, the accretion of progressively higher highs and higher lows – in a large number of phenomena – brought us to a macro-high that hadn't been witnessed for many years and held great danger . . . as we're seeing.

Forty years have passed since I first served as a summer trainee in First National City Bank's Investment Research Department. My experience in seeing investors punished in 1969-70, 1973-74, 1977, 1981, 1987, 1990, 1994 and 2000-02 is what enabled me to detect the excesses of 2003-07. But since I didn't live through the Great Depression or work through the full run-up to the painful 1970s, I didn't have the perspective needed to understand where those relatively short cycles of boom/bust/recovery were taking us.

Long-Term Trends

Looking back over my career, it's clear that the securities markets have been riding a number of salutary secular trends ("secular," as in "of or relating to a long term of indefinite duration" per *Webster's New Collegiate Dictionary*). Some of these actually began at the end of World War II and ran through 2007, for a total of more than six decades.

Macro Environment – The period following World War II was one of American dominance and prosperity. The U.S. benefited from the "baby boom," the fact that our shores hadn't been reached by the war, and the effective transition of our factories and labor force to peacetime use. We were aided by a modern infrastructure, strong education and healthcare systems, and gains in technology.

Corporate Growth – The last sixty years have seen strong growth in corporations and their profits. Especially in the early part of this period, the U.S. developed superior products, produced them very efficiently and found ready markets in the rest of the world. Gains in automation, information technology, management practices and productivity all contributed. Growth in sales was supported by strong consumer demand.

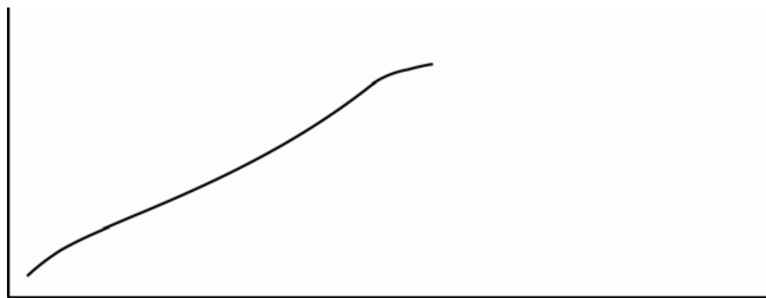
The Borrowing Mentality – As further discussed below, advances in financing – and greater acceptance of the use of debt – allowed companies to augment their growth rates and returns on capital and allowed consumers to increase consumption. In fact, over the last several decades, economic units of all sorts in the U.S. increased their use of debt. Consumers, businesses, governments and investors all wanted to borrow more, and the financial services industry developed products to accommodate them. Spending and

investment was facilitated through the extension of credit at all levels, contributing to economic expansion but also sowing the seeds for the current situation.

Popularization of Investing – Back in 1968, working in investment management was no different from entering banking or insurance. Investing wasn't the high-profile area it's been the last two decades. "Famous investor" was an oxymoron; none were household names, like Warren Buffett, George Soros and Peter Lynch would become. Investment firms weren't the B-school employer of choice, and investment managers didn't dominate magazine covers and the top income brackets. But over the last forty years, increased attention was paid to equities, mutual funds, hedge funds and alternative niche markets. Even homes came to be viewed as investment vehicles.

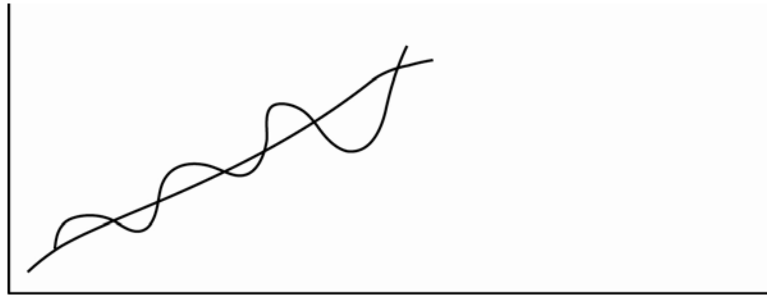
Investor Psychology – Attitudes morphed over time. Instead of a generation scarred by the Great Depression, people became increasingly confident, optimistic and venturesome. Experience convinced prospective investors that stocks could be counted on for high returns. In the last few decades, there've been times when people concluded the business cycle had been tamed. During Alan Greenspan's reign, people came to believe inordinately in his ability to keep the economy growing steadily. And most recently, people swallowed the canard that innovation, financial engineering and risk modeling could take the uncertainty out of investing.

The developments enumerated above constituted a strong tailwind behind the economy and the markets over the last several decades, and they produced a long-term secular uptrend.



Short-Term Cycles

Despite the underlying uptrend, there's been no straight line. The economy and markets were punctuated every few years by cyclical bouts of short-term fluctuation. Cycles around the trend line made for frequent ups and downs. Most were relatively small and brief, but in the 1970s, economic stagnation set in, inflation reached 16%, the average stock lost almost half its value in two years, and *Business Week* magazine ran a cover story trumpeting "The Death of Equities." No, my forty years haven't been all wine and roses.



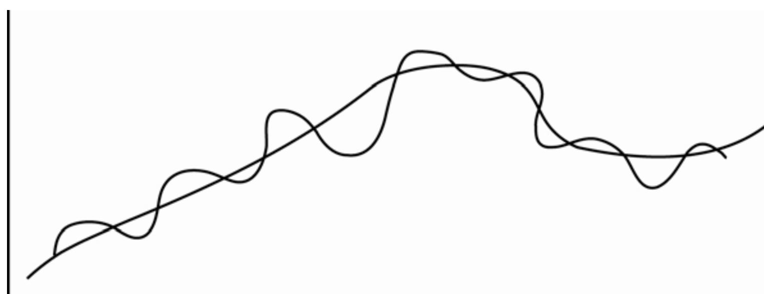
From time to time we saw better economies and worse – slowdown and prosperity, recession and recovery. Markets, too, rose and fell. These fluctuations were attributable to normal economic cycles and to exogenous developments (such as the oil embargo in 1973 and the emerging market crisis in 1998). The S&P 500 had a few down years in the period from 1975 to 1999, but none in which it lost more than 7.5%. On the upside, however, 16 of those 25 years showed returns above 15%, and seven times the annual gain exceeded 30%.

Despite the ups and downs, investors profited overall, investing became a national pursuit, and America's richest man got that way by buying common stocks and whole companies. A serious general uptrend was underway, reaching its zenith in 2007.

The Rest of the Elephant

There's an old story about a group of blind men walking down the road in India who come upon an elephant. Each one touches a different part of the elephant – the trunk, the leg, the tail or the ear – and comes up with a different explanation of what he'd encountered – a tree, a reed, a palm leaf – based on the small part to which he was exposed. **We are those blind men. Even if we have a good understanding of the events we witness, we don't easily gain the overall view needed to put them together. Up to the time we see the whole in action, our knowledge is limited to the parts we've touched.**

Until mid-2007, my experience as a money manager had been limited to part of the long-term story. Perhaps **what looked like an underlying long-term uptrend should have been viewed instead as the positive part of a long-term cycle incorporating downs as well as ups.** Only when you step back from the beast can you gauge its full proportions.



Cycles in Long-Term Trends

The main thing I want to discuss in this memo is my realization that there are cycles in the long-term trend, not just short-term cycles around it, and we've been living through the positive phase of a big one.

Over the last few decades, investors have reacted to the generally positive economic environment by taking actions reflecting increased optimism and trust, as well as reduced caution and conservatism. **In hindsight, we can see nearly uninterrupted growth in behavior that (a) relied on a continuation of the favorable underlying trends and thus (b) can be described as increasingly bullish.**

Looking for just one word, I'd say there was a steady rise in "willingness." Over my forty years in business – but probably carrying on from the end of the World War II – I believe investors grew increasingly willing . . .

- to forget old-fashioned concepts like "saving for a rainy day," fiduciary responsibility and preservation of capital,
- to pursue capital appreciation rather than settle for more modest, steady income,
- to invest on the basis of growth potential rather than existing value,
- to trust that stocks would provide superior performance (see separate section below),
- to drastically reduce the representation of high grade bonds in portfolios,
- to move away from stocks and bonds and toward more exotic investments,
- to believe that diversification into risky assets would increase return more than risk,
- to pursue profit through proprietary investing if you were a bank or investment bank, and for endowments to try to be "more like Yale,"
- to assume that markets would function smoothly even in tough times,
- to trust in markets to solve all problems, induce constructive behavior and efficiently allocate capital, allowing regulation to be reduced,
- to accept that, thanks to market efficiency, asset prices are always "right,"
- to trust in the Fed, Alan Greenspan and the ability to restrain cycles,
- to rely on quants and financial engineers, spreadsheets and risk modeling,
- to feel confident they had a good handle on what the future held,
- to believe in alpha, absolute return, widespread genius among money managers, free lunches, and superior asset classes regardless of how they're priced,
- to revere and trust money managers sporting good returns,
- to share investment gains with money managers, perhaps in ways that motivated them to take increased risk in pursuit of short-term profits,
- to view houses, art, jewelry and collectibles as financial assets,
- to believe that real estate prices couldn't go down,
- to treat investing as a national pastime via TV, magazines and books,
- to "buy the dips,"
- **to accept new paradigms,**
- **to relax diligence standards and forget to question skeptically,**

- **to use past statistical averages – sometimes covering brief time periods – to gauge the safety of prospective investments,**
- **to partake in financial innovation and invest in things too complex or opaque to be understood,**
- **to believe that risk had been banished, most recently through securitization, tranching and decoupling,**
- **to forgo liquidity,**
- **to make increasing use of leverage (see separate section below),**
- **to finance investment activities with undependable capital: short-term borrowings and deposits, impermanent equity, and future cash receipts,**
- **to forget to worry and be risk-averse, and thus**
- **to accept additional risk at shrinking risk premiums.**

The "era of increasing willingness" carried many trends to higher highs. The last ten listed above were the prime ingredients giving rise to the current crisis. Together they produced an investment house of cards that was enormously dependent on continued prosperity, bullishness and easy money.

Expansiveness

In addition to "willingness," one of the most significant trends during the period under discussion has been a massive increase in "expansiveness," my new label for the desire to increase the ratio of activity to capital. If that sounds unfamiliar, the common term in America is "leverage," and in England it's "gearing."

My last memo was on the subject of leverage and its major role in the crisis we're all experiencing. Today's problems are largely a function of the high levels of leverage employed in 2003-07, but those levels were just the apogee of a progression that spanned decades.

Every business, government, non-profit organization or individual has a certain amount of equity capital, net worth or surplus. That capital, in turn, will support a certain level of activity: production and sales, lending, government action, charitable grants or consumption. **But over the last several decades, if you wanted to do more of these things than your capital permitted, you could borrow capital from someone else.**

Over the course of my lifetime, there have been extraordinary changes in the extent of borrowing:

- **Consumers** – When I went off to college 45 years ago, I paid for purchases with checks or cash, and I saved up coins for the payphone. "Travel and entertainment" cards like American Express and Diners Club were available only to those with top credit ratings, and the masses lived without credit cards until Citibank introduced The Everything Card (now MasterCard) around 1967. In the old days, consumers who lived beyond their incomes were often described as being "in debt." We don't hear

that term anymore, since people with unpaid credit card balances and consumer loans are the rule, not the exception. As a result, consumer credit outstanding grew 260 times from 1947 to 2008, increasing from 4.2% of gross domestic product to 17.9%. (Federal Reserve data and Economagic)

- **Homeowners** – In the old days, homebuyers, having saved for years, usually put down 20% of the cost of a home and borrowed the rest through a thirty-year fixed-rate mortgage. They made payments until that debt was eliminated, and they held mortgage-burning parties to celebrate the event, which would enable them to retire mortgage-free. Only people who were "in trouble" took out second mortgages, perhaps to meet emergency expenses. All of these concepts went out the window in recent times, when down payments, fixed rates and paid-off mortgages became things of the past, replaced by 100% financing, adjustable rates, teasers and serial refinancings. Second mortgages were relabeled "home equity loans," little miracles that would let people draw out the inevitable appreciation in their homes, spend it, and end up with the same home and larger payments – perhaps just as interest rates moved up or as the borrowers hoped to be able to retire.

- **Corporations** – "In the beginning," corporate borrowing was most undemocratic. Prior to the late 1970s, only firms with investment-grade credit ratings of triple-B or better could publicly issue bonds. But that changed with the introduction of high yield bonds, an innovation permitting low-rated issuers to borrow at high interest rates. Before the advent of high yield bonds, companies could be acquired only by companies bigger than themselves. But with high yield bonds, small firms and even wealthy individuals could borrow enough to acquire corporate giants. This created the leveraged buyout industry. In recent years, not only was debt added to capital structures (particularly through buyouts), but equity was subtracted. Buyout companies used borrowed funds to dividend out their owners' equity and provide quick profits, and non-buyout companies bought back their shares, often using borrowed money. These activities substituted debt for equity in companies' capital structures, levering up their results and reducing their margin for error. In the current credit crisis, this has led to large-scale capital destruction.

- **Financial Institutions** – Over the decades in question, banks and investment banks moved away from working for interest, fees and commissions as lenders, advisers, brokers and agents. Instead, they went increasingly into positioning (buying or selling blocks of stock to accommodate clients when the market wouldn't take that side of a trade), proprietary trading (making investments for their own accounts, not on behalf of clients), and creating derivatives (sometimes ending up with a holding), all on the basis of increased leverage. "In 1980, bank indebtedness was equivalent to 21 percent of U.S. gross domestic product. In 2007 the figure was 116 percent. . . . It was not unusual for investment banks' balance sheets to be as much as 20 or 30 times larger than their capital, thanks in large part to a 2004 rule change by the Securities and Exchange Commission that exempted the five largest of those banks from the regulation that had capped their debt-to-capital ratio at 12 to 1." (*Vanity Fair,* December 2008)

- **Governments** – Similarly, governments at all levels learned increasingly to spend borrowed money in addition to their revenues. Federal, state and local debt ballooned to facilitate both capital projects (reasonably) and deficit spending (less reasonably). The Federal debt grew from $1 trillion in 1980 to $11 trillion today. How? In 2003 and 2004, for example, the government spent $1.42 per $1 of income taxes. In this way, the U.S. became a debtor nation, dependent on bond buyers – particularly from abroad – to let it spend beyond its means. Likewise, state and local debt grew from $1.19 trillion in 2000 to $1.85 trillion in 2005, an average increase of 9.2% per year. In an extreme example of unwise innovation, much of the issuance of muni bonds was made possible because weak issuers could obtain bond insurance; few prospective investors, however, looked into the financial strength of the insurers.

- **Investors in General** – Fifty years ago, the main way investors expanded their activities was through the use of "margin," borrowing from their brokers to buy stock. Initial margin for new purchases was strictly limited to 100% (e.g., at most you could buy $2 worth of stock for every $1 of equity in your account). But Wall Street proved increasingly creative, and in the current decade it came up with products "with the leverage inside." These made much more than 100% leverage available to investors without any explicit borrowing. Hedge and arbitrage funds, collateralized loan obligations, collateralized debt obligations, leveraged buyout funds, credit default swaps and other derivatives; all of these delivered participation in highly leveraged investments without requiring the end investor to use margin or take out loans. In what approached a joke, the prim limit on margin was maintained even as regulators declined to apply any limits or regulation to these other investment structures, despite their ability to provide almost infinite leverage.

- **Institutional Investors** – Given their tax-exempt status, pension funds and charitable and educational endowments can't borrow to increase their returns. But they can (and did) make use of some of the strategies listed above. Institutional investors also employed "portable alpha," overlaying hedge fund investments with index futures to simulate more-than-100%-invested positions, and they overcommitted to private equity partnerships to ensure their capital would be fully deployed.

The use of borrowed money expanded at all levels over the last few decades. This occurred largely without changes in laws or institutions. Instead, the changes were in customs and attitudes, abetted by financial institutions' innovation of new products.

<u>Of all the investment adages I use, this one remains the most important: "What the wise man does in the beginning, the fool does in the end</u>." Practices and innovations often move from exotic to mainstream to overdone, especially if they're initially successful. What early investors did safely, the latecomers tried in 2003-07 with excessive leverage applied to overpriced and often inappropriate assets. As I wrote in "It's All Good" (July 2007), leverage was the "ketchup" of this period, used to make unattractive underlying investments appear tasty. The results have been disastrous.

Here's another way to put it, from *The Wall Street Journal* of November 24,

> When it comes to booms gone bust, "over-investment and over-speculation are often important; but they would have far less serious results were they not conducted with borrowed money."

That statement wasn't made in reference to current events; that was Irving Fisher writing 76 years ago ("The Debt-Inflation Theory of Great Depressions," *Econometrica*, March 1933). Borrowed money lets economic units expand the scale of their activity. But it doesn't add value or make things better; it just makes gains bigger and losses more painful. There's an old saying in Las Vegas: "The more you bet, the more you win when you win." But they always forget to add ". . . and the more you lose when you lose."

In one of those beautiful phrasings that demonstrate his mastery of language, Jim Grant of *Grant's Interest Rate Observer* has described liquidity and leverage as **"money of the mind."** By this he means they're intangible and ephemeral, not dependable like assets or equity capital. Someone may lend you money one day but refuse to renew your loan when it comes due. Thus, **leverage is purely a function of the lender's mood.** The free-and-easy lending of 2003-07 has turned into an extreme credit crunch, and the unavailability of credit is both the root and the hallmark of today's biggest problems. **Those who expand the scope of their operations on the basis of borrowed money should always consider the possibility that lenders will change their mind.**

<u>Use of Debt in the Corporate World</u>

Note three things regarding debt. **First, all businesses borrow**. Debt is used broadly to finance things ranging from inventories to capital investment. If companies had to wait to get paid by buyers before ordering new goods to sell, business would go much slower. And if all their capital had to be equity, capital would be much more costly and companies would be much smaller. Borrowing makes the business world go 'round.

Second, debt is rarely repaid. Businesses rarely reduce their total indebtedness. Rather than being paid off, debt is simply rolled over. That makes the solvency of the borrowers contingent on the continuous availability of credit.

Third, given that the yield curve normally slopes upward, short-term borrowing is almost always the least expensive. That's what led First National City Bank to invent commercial paper in the 1960s, enabling companies to borrow at short-term rates through short-dated paper that would be renewed every month or so. The upward slope of the yield curve encourages people to borrow short even when investing long, resulting in economic maximization when they're able to roll over their debts but disaster when they aren't. (The recent failure of "auction-rate preferreds" was a good example of the folly of trying to game the yield curve by financing for the long term at short-term rates.)

Here's what follows from the above:

- Most companies have debt, not just those that have made acquisitions or built plants. Companies borrow in the normal course of business.
- Many companies have heavy short-term borrowings and thus the need to deal with substantial maturities in the period immediately ahead.
- With the capital markets closed, not only will growth be difficult to finance, but significant defaults may also arise due to a widespread inability to refinance.

While I always hesitate to predict the future, I think there's a good chance the next year or so will be characterized by significant difficulty repaying and refinancing borrowings. It's worth noting in that context that "In November, there wasn't one sub-investment grade corporate bond issued, according to Reuters – the first such hiatus since March 1991." (*breakingviews.com*, December 3)

Attitudes Regarding Equities

One of the biggest changes in the past century – fully visible only to those who already were adults several decades ago or who've read about it – took place in terms of attitudes towards equities (or what we used to call common stocks).

Up until the middle of the last century, stocks were considered highly speculative, and bonds were the bedrock of most investment portfolios. Interestingly in that connection, it was reported recently that the S&P 500 now out-yields the 10-year Treasury for the first time in 50 years. **Until the 1950s, equities always provided higher current yields . . . for the simple reason that they had to. People invested primarily for yield, and riskier securities – stocks – would attract buyers only if they promised higher yields than bonds.**

This changed in the second half of the 20th century:

- Common stock investing was popularized; I believe Charlie Merrill of Merrill Lynch deserves a lot of the credit for this.
- Prior to some pioneering computer work at the University of Chicago in the 1960s, the historic returns on stocks had never been scientifically quantified. Then the Center for Research in Security Prices came up with the 9.2% compound annual return that fired many investors' appetites.
- The concept of growth-stock investing was popularized in the 1960s; I remember reading a broker's brochure about companies with exciting earnings growth. This led to the "nifty-fifty" investing craze, in which investors (and especially bank trust departments) bought the stocks of fast-growing companies regardless of valuation.

The equity boom burst in the 1970s. We experienced an oil embargo, a very serious recession, inflation rates ranging up to 16%, a 45% decline in the S&P 500 in 1973-74,

and considerably larger losses in nifty-fifty stocks. The stock market stayed in the doldrums for years, brokers drove cabs (literally), and *Business Week* ended a dismal decade with its downbeat cover story on stocks.

In fact, the economy, markets and attitudes turned so negative for so long in the 1970s that rather than a ***downward cycle around*** **the long-term upward trend,** one might say the decade marked a ***downturn in*** **the long-term trend** (clearly there's no standard for these things). Regardless of what you call it, the decline was so big that it took almost eleven years for the Dow Jones Industrials to get back to the high it reached at the beginning of 1973.

But in 1982, stocks returned to what would be a 25-year bull market, and there arose an even greater cult of equities. Wharton Professor Jeremy Siegel wrote *Stocks for the Long Run,* showing there'd never been a long period in which stocks hadn't outperformed cash, bonds and inflation. Everyone concluded stocks were the asset class of choice and the ideal investment. "65/35" was the usual stock/bond balance in institutional portfolios, but eventually stocks became more heavily weighted, as strong performance in the 1980s and '90s further fired peoples' ardor and as stocks' long-term return was upgraded to 11%. **Few investors recognized that increasing past returns bode poorly – not well – for subsequent returns, or that common stock returns couldn't forever outpace the rate of growth in corporate profits.** In 1999, James Glassman chimed in with his book *Dow 36,000*, asserting that because stocks were such solid investments, equity risk premiums were higher than they should have been, meaning their prices were too low. That pretty much marked the long-cycle top.

When the "tech-media-telecom" bubble burst in 2000, stocks went into their first three-year decline in almost 70 years. The broad indices stabilized after 2002 and returned to their 1999 highs in 2007 but, wanting more than equities' unlevered return, investors shifted their focus to private equity and to equity hedge funds. All of this occurred just in time for the onset of the credit crisis. Last year's 38.5% decline in the S&P 500 was the biggest since 1931, zeroing out more than a decade of gains.

I wonder whether and to what extent equities will be returned to the pedestal of popularity. *The Wall Street Journal* put it aptly on December 22:

> One of the hallmarks of the long market downturns in the 1930s and the 1970s has returned: Rank-and-file investors are losing faith in stocks.
>
> In the grinding bear markets of the past, huge stock losses left individual investors feeling burned. Failures of once-trusted firms and institutions further sapped their confidence. Many disenchanted investors stayed away from the stock market, holding back gains for a decade or more.
>
> Today's investors, too, are surveying a stock-market collapse and a wave of Wall Street failures and scandals. Many have headed for the exits:

> Investors pulled a record $72 billion from stock funds overall in October alone . . . .
>
> If history is any guide, they may not return quickly.

I want to make a heretical assertion: that equities aren't the greatest thing since sliced bread, but rather an asset class that can do well or poorly depending on how it's priced. Investors fell into a trap at the 1999 peak because they were seduced by stocks' long-term average return in addition to their recent gains. Rather than ask "What's been the historic return on stocks?" they should have asked "What's been the historic return on stocks if you bought them when the average p/e ratio was 29 (which it was at the time)?" Once again, investors came to believe in the magic asset class and forgot the importance of reasonable valuation.

The truth is, rather than being superior, equities are an inferior asset class . . . structurally, that is. Unlike debt, they don't promise annual interest or repayment at maturity, and they don't carry a senior claim against the company's assets in case of trouble. All they offer is an uncapped participation in profits. Debt promises a stream of contractual payments, and common stocks provide the residual that remains after those payments have been made. **Thus equities' higher historic average and potential future returns should be viewed as nothing more than compensation for their inferior status and greater volatility. They're not magic, just securities that can perform well when they're priced right for the coming profits. If sluggish growth lies ahead for the economy in the next few years, it's no given that common stocks will outperform corporate bonds.**

<u>Go Around, Come Around</u>

Mark Twain is alleged to have said "History doesn't repeat itself, but it does rhyme." Mistakes follow long-standing patterns, but applied in new ways. Thus it's worth noting a few of the many ways in which events of the pre-crisis years are reminiscent of the Roaring Twenties that preceded the Great Crash.

- In the 1920s, stock manipulators banded together to force down the price of stocks through non-stop short selling. The damage caused by these "bear raids" led to implementation of the "uptick rule," under which shares could be shorted only at prices higher than the last. This rule made it hard for short sellers to drive down prices, and it remained in effect right up until July 2007. Its elimination enabled bears to once again drive down the stocks of weakened financial institutions, an emblematic event in 2008.

- The combination of banking and investment banking under the same roof received a good part of the blame for the Great Crash (see one of my favorite books, *Wall Street Under Oath* by Ferdinand Pecora, 1939). This led to passage of the Glass-Steagall Act mandating separation of the two. It was revoked in 1999, and when they were

recombined, the battle between bankers' caution and investment bankers' risk tolerance was won by the latter, putting institutions that were "too big to fail" in jeopardy. This played no small part in the current crisis.

- Also in the '20s, "bucket shops" provided easy access to investment risk. They would take "side bets" on the direction of stocks from small customers without actually sending orders to the exchange. Instead, they'd throw order slips "in the bucket" and hold the risk themselves. *Voilà*: investment exposure without a stock market transaction. The other day, Charlie Munger reminded me of the similarity of bucket shops to today's derivative contracts, which likewise permit bets on investments without any actual transactions taking place in the underlying securities. Massively levered derivatives played a big part in this decade's build-up of risk.

Developments like these don't happen randomly. They're the logical next step after optimism and ardor have increased, caution has subsided, and the desire for protective regulation has abated. The relaxation of worry eventually leads to environmental changes that permit excesses.

The Culmination

When the long-term pendulum is at its negative extreme, it can be counted on to turn for the better at some point, passing the midpoint and continuing toward the positive part of its arc. Eventually the pendulum will reach an apex so high that it'll be incapable of staying there. Then it will swing back, whether under its own weight or because of exogenous forces, or both. **In the course of moving from merely heated to torrid, however, I believe it can be counted on to bring out behavior which is manic and dangerous.**

The current long-term cycle may have begun in the post-World War II recovery. It benefited from the positive factors discussed on pages 2 and 3 and resulted in great capital creation for consumers, homebuyers, businesses, non-profits and investors. But it continued on from "healthy" to "excessive," resulting in the events of the last eighteen months, many of which can be summed up under the heading of capital destruction.

The greatest single example may be the case of Bernard Madoff, in which a trusted, high-performing investment manager allegedly fabricated his record, deceived friends and strangers alike, and lost or stole $50 billion. An increase in fraud can be viewed as a normal component – in fact, perhaps emblematic – of frothy, cycle-driven markets. Who hears of embezzlement during bearish times? A few lines from the *Financial Times* of December 20 indicate the cyclical aspects of the Madoff affair:

> The size of the alleged Bernard Madoff scam . . . is astounding, yet unsurprising. History tells us that bubbles spawn swindles. After the biggest credit bubble of all time, we now may have the biggest swindle of all time. . . . The historian Charles Kindleberger believed that "swindling

> is demand-determined, following Keynes's law that demand determines its own supply. . . ."
>
> Mr. Madoff's story was dull . . . but compelling in a credit bubble where yields were everywhere falling. . . .
>
> When a wave of redemptions hit the Madoff funds, the Ponzi scheme . . . became unworkable. . . . Reputations inflated in the bubble [of the 1920s] promptly evaporated in the 1929 crash, which exposed a plethora of swindles. Redemptions of the hedge funds business are having the same effect today.

Having appreciated in the up cycle, mainstream securities offered only meager returns going forward, causing investors to turn elsewhere. Madoff's steady 10-11% returns wouldn't have blown off anyone's socks in the 1990s, but they were enticing in the 2000s. **Add in the optimism, credulity and loosey-goosey attitudes that always accompany the top of a cycle, and the atmosphere was right for what John Kenneth Galbraith called a good "bezzle."** But when things retreated from the lofty level that couldn't be maintained, investors put in for redemption and the falsehoods came to light.

The Madoff scam was cut from the same up-cycle-gone-wild cloth as the elimination of the uptick rule. Scams; unsupportable mortgages on overpriced homes; over-leveraged hedge funds, debt pools and buyouts; insurers with inadequate capital; managers incapable of doing what they said they could . . . as Warren Buffett says, they're all exposed when the tide goes out. What are the results to date? The outing of the biggest fraud in history; $1 trillion of write-offs by the banks thus far; $7.8 trillion committed to "recovery activities" by the U.S. alone; the biggest decline in the Dow Jones Industrials in 77 years; more than a decade of equity appreciation lost; the disappearance of every major U.S. non-bank investment bank; and a cry for more and better regulation. Now that the bursting of the credit bubble has affected the general economy, we're seeing declining consumer incomes, confidence and spending; plummeting home sales, home prices and housing starts; and the highest unemployment rate in many years. **All of this is part and parcel of the long-term cycle.**

<u>Trends Just Ahead</u>

Unlike the "era of increasing willingness," many things will face increased difficulty in the months and years just ahead. It'll be tougher times for anything dependent on:

- **bullishness, willingness and expansiveness,**
- **increasing economic activity and consumer spending,**
- **the ability to incur, service, repay or refinance debt,**
- **asset sales and the ability to delever, and**
- **strong asset values and investment returns.**

Clearly, it was in the financial world, not the "real world," that the great excesses of bullishness, willingness and expansiveness developed, planting the seeds for the current crisis. But financial-sector attitudes and innovations allowed excesses in all the things listed above to be visited upon the real world, where we're now experiencing difficulty in them. It's no coincidence that history-making excesses in the financial sector – and the correction thereof – led to history-making weakness in the real economy.

It may be a good while before the elements listed are fully restored and the long-term trend roars upward again. The government is doing everything it can to reinstate them, but there's no roadmap for success. We all have to wait with fingers crossed. However, in the coming period, while we'll be hoping for the short-term cycle to recover, it's quite likely that the long-term trends listed on pages 2 and 3 will be less salutary than they were in decades leading up to the current crisis.

When will cyclical recovery arrive? For this, too, there's no roadmap. Most economists rely for their predictions on models that extrapolate relationships between investment, production, employment and consumption, for example, but they omit psychological considerations such as bullishness, willingness and expansiveness. On January 3, a *New York Times* article reported that a survey of economists had found consensus that recovery would commence in the second half of 2009. But it added that the economists:

> . . . base their forecasts on computer models that tend to see the American economy as basically sound, even in the worst of times. That makes these forecasters generally a more optimistic lot . . . their computer models do not easily account for emotional factors like the shock from the credit crisis and falling housing prices that have so hindered borrowing and spending.
>
> Those models also take as a given that the natural state of a market economy like America's is a high level of economic activity, and that it will rebound almost reflexively to that high level from a recession.
>
> But that assumes that banks and other lenders are not holding back on loans, as they are today, depriving the nation of the credit necessary for a vigorous economy.

These forecasters might assert that their models have worked on average. But I'd guess the period during which they worked didn't include sluggishness in long-term trends of the nature I'm discussing here. **Recognizing times when historic data shouldn't be extrapolated is an important part of dealing prudently with the future.**

Importantly in this context, I want to point out that the recent decades shouldn't be considered a norm to which we're sure to return. Instead, they were the best of times. Most years saw good returns; most investments paid off (often the riskier the better); and most investors made a lot of money. The financial services industry

prospered, and its people made a lot of money and had inordinate fun doing so. From 1987 to 2007, "securities, commodity contracts, and investments" grew twice as fast as total gross output. And according to *The New York Times* of December 19, in 2007, ". . . the average salary of employees [in that category] was more than four times the average salary in the rest of the economy."

In other words, it was high tide. All financial boats were lifted, obscuring who was swimming without a bathing suit. In times like those, you can make money through skill or just aggressiveness, and it's hard to tell which is which.

In my view, superior investors are the ones who make more money in the good times than they give back in the bad. The ebb tide in the next few years will show us which they were. Managers who perform relatively well for their clients in this period will be recognized and rewarded. The rest shouldn't be able to amass funds or command fees as effortlessly as they did in the past. Of course, we hope Oaktree will be among the former. We'll all know in a few years. **In the new, chastened environment, I don't think anyone will jump to conclusions as readily as they did in the past.**

The other day, I was speaking with a reporter who summed up what I had said: "So skepticism will be greater; investors will be more risk-averse; fund raising will be harder; and fees will receive more scrutiny. That'll be worse for business, right?" For the short run and for managers who failed their clients, it likely will. **But in the long run, it'll make for a much healthier environment for all of us.**

<u>The Importance of the Long View</u>

As usual, some of the most important lessons concern the need to (a) study and remember the events of the past and (b) be conscious of the cyclical nature of things. Up close, the blind man may mistake the elephant's leg for a tree – and the shortsighted investor may think an uptrend (or a downtrend) will go on forever. But if we step back and view the long sweep of history, we should be able to bear in mind that the long-term cycle repeats and understand where we stand in it. The failure to do so can be most painful. John Kenneth Galbraith provided a reminder in *A Short History of Financial Euphoria*:

> Contributing to . . . euphoria are two further factors little noted in our time or in past times. The first is the extreme brevity of the financial memory. In consequence, financial disaster is quickly forgotten. In further consequence, when the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at

> all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.

Jim Grant did a good job of putting a cyclical movement into perspective in the January 31, 2003 issue of *Grant's Interest Rate Observer*:

> Wall Street today is in one of its recurrent sinking spells. Many call it a crisis of confidence, by which they mean under-confidence. Less attention is given to the preceding crisis of overconfidence. Material progress is cumulative, but markets are cyclical. First, investors trust too much, then they doubt too much. They believe that no price is too high to pay for a stock or a bond, then they doubt that any price is too low. So credulity is followed by cynicism, unreasonably high prices by ridiculously low ones.

Central banks will try to stabilize economies, and company managers will strive for smooth earnings growth. But as long as human beings determine security prices, market cycles will be the rule, not the exception. The extremes of greed, fear and worry over missing out will never be banished.

At times investors will be too risk-tolerant, and at others they'll be too risk-averse. They'll forget to inquire skeptically after things have gone well for a while, just as they'll ask too many questions and hesitate too much when recent events have decimated securities prices (and investors' psyches). **As little as two years ago, investors rushed headlong into things, fearing that if they didn't, they'd miss out on big gains. Now they're keeping their money in their wallets, saying "I don't care if I ever make a penny in the market again, I just don't want to lose any more." This change in attitudes – throughout the financial system – is responsible for a lot of today's deep freeze.**

Over the last several decades, our economy and markets benefited from positive underlying trends and investors were well rewarded for bearing risk. As a result, there was rising bullishness, willingness and expansiveness. When these trends reached unsustainable excesses, they were corrected with a vengeance. **I'm now of the opinion that not only will short-term economic cycles of boom and bust repeat regularly, but also that favorable long-term trends are bound to see a recurrence of this sort of occasional massive pullback . . . at that moment when the passage of time has erased all memory of past corrections and taken investor behavior (and thus asset prices) to unsustainable highs.**

Buoyant, decades-long up-trends and their explosive endings are the inevitable results of the tendency of human nature to go to extremes. Hopefully the current bursting of the long-term bubble will end within the next few years, and hopefully the next iteration is another 30, 50 or 70 years away. This one's providing enough excitement for a lifetime.

January 9, 2009

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Memo to: Oaktree Clients

From: Howard Marks

Re: Will It Work?

The other day, my son Andrew – college senior and credit-analyst-to-be – asked whether I think Treasury Secretary Geithner is doing the right things. As has happened before, his question elicited a fatherly response that grew into this memo.

When you want a bridge built, you hire a civil engineer whose "calcs" will determine exactly how much concrete and steel should be used. Then it'll be sure to hold the weight of the cars you expect to cross it. And if you have to perform a task in carpentry, you can employ specialized tools developed and tested expressly for the job: esoteric things like miter boxes, routers and extractors.

One of the most important things to bear in mind today is that **economics isn't an exact science.** It may not even be much of a science at all, in the sense that in science, controlled experiments can be conducted, past results can be replicated with confidence, and cause-and-effect relationships can be depended on to hold. It's not for nothing that economics is called "the dismal science."

Solutions in economics aren't nearly as dependable as engineers' calculations, and there may not be a tool that's just right for fixing an economy. Of course, the toolbox offers lots of possibilities, including interest rate reductions; quantitative easing; tax cuts, rebates and credits; stimulus checks; infrastructure spending; capital injections; loans, rescues and takeovers; regulatory forebearances and on and on. **But no one should think there's a "golden tool," such that solving the problem is just a matter of figuring out which one it is and applying it.** Anyone who holds the problem solvers to that standard is being unfair and unrealistic. There are a number of reasons why, including these:

- Every situation is different, and none is exactly like any that has come before. That means fixed recipes can't work. Certainly this one has never been seen before.
- Most policy actions aren't all good or all bad. They merely represent imperfect compromises as to ideology, goals, problem solving and resource allocation.
- Economic problems are multi-faceted, meaning the solution for one aspect might not work on – and in fact might exacerbate – another aspect.
- Economies are dynamic, and the problems are moving targets. The environment changes constantly, rather than sitting still and waiting for a solution to work.
- **The main ingredient in economics is psychology, and the workings of psychology clearly can't be fully known, controlled or fixed.**

Here's how Thomas Friedman put it in *The New York Times* of January 31:

> Everyone is looking for the guy – the guy who can tell you exactly what ails the world's financial system, exactly how we get out of this mess and exactly what you should be doing to protect your savings. . . . But here's what's really scary: the guy isn't here. He's left the building. . . .
>
> There is no magic bullet for this economic crisis, no magic bailout package, no magic stimulus. We have woven such a tangled financial mess with subprime mortgages wrapped in complex bonds and derivatives, pumped up with leverage, and then globalized to the far corners of the earth that, much as we want to think this will soon be over, that is highly unlikely.

The "I know" school (which first appeared in a memo in 2001) is still making predictions. Statistical comparisons are being made to past recessions and solutions extrapolated from those experiences. Thus it's the consensus of this school that the recovery will start during the first quarter of 2010. I also see people projecting a stock market rebound based on the average time between past declines and the recoveries therefrom.

I think it's a mistake to hold confident opinions about the events of today. Instead, I think this is a great time to reaffirm faith in the "I don't know" school, of which I'm a card-carrying member. No one should feel certain they know what's going to unfold, or when. **<u>The only things we have to fall back on at this juncture are intrinsic value, company survival and our own staying power as investors</u>. Of course, even these things mean we have to make judgments about what the future is likely to look like. That requirement, in turn, means nothing can be approached with complete safety or certainty. Nevertheless, we can take action if we think those three elements will be present under most circumstances. That's the right mindset for today.**

<u>Harder Than Sudoku</u>

The impossibility of reaching into the economic toolbox for that one perfect tool is easily illustrated with a list of some of the challenges present today. For a learning exercise, skip today's Sudoku or crossword puzzle and take a crack at resolving these dilemmas:

- Consumer confidence and spending are weak. We want to stimulate, but we don't want to replace weakness with hyperinflation.
- We're willing to drop fiscal discipline in favor of stimulus through deficit spending, but we don't want to scare away offshore investors from the Treasury securities we'll issue to fund our deficits.
- We're willing to distribute stimulus checks, but we seem unable to make frightened individuals spend the money rather than save it.
- In fact, we know consumers got into trouble by spending more than they earned, and

now they should build some savings. But whereas in the recent past consumer spending grew faster than incomes, a rising savings rate means spending would grow slower than incomes, just at a time when incomes are falling and spending is needed.

- Likewise, with tax revenues down, states and cities have to balance their budgets. One way to do so is to raise income tax and sales tax rates, but this will further depress local economies and increase the burden on their beleaguered citizens.
- We want to recapitalize the banks, but we don't want to reward past mistakes.
- We're thinking about buying the banks' "toxic" assets. But if we pay above-market prices, that's a subsidy to the reckless (see above), and if we pay market or below-market prices, that will further erode bank capital through write-downs.
- We know suspending mark-to-market accounting would end write-downs, but doing so might also reduce confidence in balance sheets and postpone the day of reckoning needed for our financial institutions to reach bottom and recover.
- We want the banks to lend, but we can't – and shouldn't – make them extend loans to non-creditworthy borrowers.
- We want to reduce the incidence of home foreclosure, but we don't want to reward people who speculated by buying multiple homes or lied on mortgage applications. And we'd rather not treat people who bought more house than they could afford better than those who acted prudently.
- We want to make mortgage relief available to those who are unable to service their mortgages, but we don't want to give people incentives to stop making payments.
- We're considering letting bankruptcy judges reset mortgage contracts, but we don't want to tell lenders that loan contracts are no longer sacrosanct, which certainly would deter them from making new loans.
- We don't want the depressant impact of auto companies going bankrupt and suppliers and dealers following suit. But we also don't want to pump money into the industry unless we're confident it can produce good cars at competitive prices.
- We want to see the auto industry "rationalized," but that means seeing people lose their jobs or have their paychecks reduced, which would spread pain, put stress on benefit funds, and cut into GDP.
- We want taxpayer-supported automakers to use American steel, but (assuming it's more expensive than imported steel) that will either (a) raise car prices, making cars more expensive for hard-pressed buyers and making the Big 3 less competitive, or (b) require the companies to eat the difference, making it harder for them to achieve profitability.
- We want to curb speculation in derivatives, but we don't want to make it harder for businesses, farmers, insurers and investors to legitimately hedge risk.
- In fact, we want to prevent excesses on the part of business, but most people don't think it's a good idea to nationalize companies or have the government tell them how to operate.

It's abundantly clear from this list – and it's only a partial list – that solving the current problem will require compromises and a combination of disparate elements. Some will work, while others will fail and have to be replaced. And some will work with regard to one facet of the problem but aggravate another. Lastly, no one should think that even a wise combination will produce quick results.

Regulating Excess Compensation

Some of the excesses the government wants to stop are in the area of compensation at rescued banks. Excessive compensation seems to have a lot in common with hard-core pornography: As Potter Stewart, Associate Justice of the United States Supreme Court, wrote about the latter, it's hard to define but "I know it when I see it."

It's easy to react adversely when an institution that lost billions and needed a taxpayer bailout is seen paying millions or billions in executive bonuses. But how do we define excessive compensation, and what should be done about it? **More importantly, how do we make sure the cure won't be worse than the disease?**

On February 14, *The Wall Street Journal* reported that,

> The giant stimulus package that cleared Congress Friday includes a last-minute addition that restricts bonuses for top earners at firms receiving federal cash . . . The most stringent pay restriction bars any company receiving funds from paying top earners bonuses equal to more than one-third of their total annual compensation.

Some limitation on compensation at taxpayer-supported institutions seems reasonable and unavoidable. But is this provision a good thing? Here are some of the problems:

- It doesn't limit compensation, just bonuses.
- **Bonuses – especially if tied to achievements – should be preferable to high salaries from the point of view of shareholders and taxpayers**. In fact, it was just a few years ago that federal legislation created a preference for incentive compensation tied to benchmarks.
- An executive with a $1 million salary is in compliance with this restriction if he receives a bonus of $500,000. But one who's paid $250,000 is in violation if he receives a bonus of $200,000. Should the taxpayer prefer the former to the latter?
- Past challenges, like mobilizing industry for World War II, were met by recruiting "dollar-a-year" leaders. **One hope here might be that able businesspeople will come forward to work for nothing but a big success fee**. Citigroup CEO Vikram Pandit is receiving a salary of $1. Should we really limit his bonus to 50 cents?
- **The new law will limit bonuses at taxpayer-assisted banks, not all banks. Will that doom the rescued banks to second-rate management? And thus second-rate profitability? Is that desirable?**
- **Bank managements and boards may want to avoid this limitation, and to do that they may turn down or rush to repay federal money. Doing so may reduce the banks' capital, weakening them and inhibiting their ability to lend.**
- Even the biggest losers among the banks had some profitable units and excellent managers. Do we want the weak institutions to lose these to their stronger peers because they can't pay competitively?
- **Does the fact that some bank managers made grave mistakes in recent years mean no bank executives can be deserving of high compensation? Does the**

government really want to stigmatize the field of banking and chase able executives from it to industries where compensation is unregulated?

- The last time I saw legislation with near-unanimous appeal on a corporate-behavior issue was in 2002, after the Enron scandal. American business is still suffering from some of Sarbanes-Oxley's less-well-conceived provisions.

Observers are disappointed when recovery plans aren't announced quickly or in detail. Yet here's a provision that was inserted quickly and in detail, and it doesn't do a lot to advance the ball. Bottom line: a quick fix will prove hard to come by.

Who's Right?

My mother used to tell a story about the *shtetls* – villages – in the old country where disagreements were settled by the rabbi. In one, an argument was raging with no possible grounds for compromise. The villagers brought the two parties to the rabbi. "Tell your side," the rabbi said to one fellow, and he did. "**You're right**," the rabbi declared.

One of the bystanders piped up: "You can't tell him he's right, rabbi; you haven't heard the other side of the story." So the rabbi told the other party to tell his side, and he did. His story was the polar opposite of the other party's. "**You're right**," said the rabbi.

"Hold on, rabbi," a villager said, "the first guy told his story and you said he was right. Then the other guy told his story – different in every regard – and you said he was right. They both can't be right." "**And you're right**," said the rabbi.

The current disagreement over bank nationalization shows that (a) there can be valid arguments on both sides of an issue and (b) it can be hard to figure out who's right. Here are a few of the pros and cons as advanced by *The Wall Street Journal* on February 24:

> **What are the pluses to nationalizing firms?**
>
> Some banks are bleeding slowly toward insolvency. Nationalizing them promptly would allow the government to wipe out the most toxic assets, reorganize what is left and sell the remains to private investors. On a broader front, nationalization could help heal the banking system and encourage the remaining firms to boost lending.
>
> **What are the minuses?**
>
> Investors in the nationalized bank would likely be wiped out. And nationalizing even one or two banks could create a chain reaction of failing confidence. . . .
>
> Nationalization would also be expensive and complicated, taxing a bureaucracy that isn't set up to operate mega-firms. And while the goal of

> nationalization may be to return companies to private hands, the temptation to run them for political purposes would be immense.

Obviously, there are arguments on both sides.

<u>One Proposal</u>

The other night, I had dinner with my friend Richard Ressler, principal and founder of CIM Group. He has an idea as to how things can be fixed (as usual), and it's a pretty good one. I'll summarize below his thoughts on the banking industry:

- There are banking institutions which, because of their magnitude and significance, should be supported through deposit insurance, government guarantees and rescues.
- These banks should engage only in the prosaic acts of accepting deposits and making loans. They should not take on ultra-high leverage or make exotic investments. And they shouldn't do business through unregulated, off-balance-sheet subsidiaries.
- Institutions that wish to do things that are off-limits to these banks should do so, but without the benefit of government protection. If they want to take on 30-times leverage and pursue proprietary profits, they should bear the consequences themselves.
- Thus banking and risky investing should be separated.

In *The New York Times* of February 2, Professor Paul Krugman of Princeton argued that we have to avoid "lemon socialism: taxpayers bear the cost if things go wrong, but stockholders and executives get the benefits if things go right." One way to prevent this, as Richard suggests, is to make sure government support and high-octane risk taking don't take place in the same firms.

I've been told it isn't his, but a saying widely attributed to Mark Twain seems to be on the mark: "History doesn't repeat itself, but it does rhyme." There's no need to invent the mechanism through which to accomplish the above; we can look to history and gain inspiration from the Glass-Steagall Act.

After the Great Crash, congressional committees investigated its causes, some of which remind one of today's. The result was this 1933 law, which mandated that banking be separated from investment banking and investment services. It's far from irrelevant to the current situation that Glass-Steagall's powers ended in 1999, when key parts were repealed by the Gramm-Leach-Bliley Act. This new law had the goal of encouraging competition in banking, investment services and insurance, by permitting common ownership by financial conglomerates.

Protecting society against risky investment activities on the part of government-insured institutions is a good thing. And competition in providing financial services is a good thing. But the two goals can be in conflict and have to be balanced, and the consensus as to which should prevail will oscillate from time to time. **So in addition to**

there not being perfect solutions, there also may not be permanent solutions. That's why crises will recur and history will continue to rhyme.

Politics as Usual

Few phrases strike terror in the hearts of businesspeople and many just-plain-citizens more than the three little words that are the title of this section. The other day, a friend with high-up experience explained the facts of life in Washington. He organized his observations into the "Three P's."

- **Policy** is fashioned through intellectual debate conducted on a high plane. Well-meaning people can disagree, but policy analysis follows from facts and underlying ideology in a relatively straightforward way.
- **Process** is the mechanism through which policy is turned into action. It is complex and arcane and the exclusive province of people with experience in Washington.
- **Politics** shapes the law that policy becomes. My friend had lots of words for it, but the one that stood out to me was "distasteful."

As an aside, my friend laid out an important difference between government and business, in which he's also highly experienced. **In business, he says, everyone's main goal is the success of the company.** Contributing to the success of the company enables an individual to demonstrate ability and thus rise in the organization. Success for the company creates a pool of profits from which the individual can be well paid. It also amounts to a "win" for a team of which every person wants to be a member.

But in government, success is hard to measure, difficult to connect to any one individual's contribution, and slow in coming. Thus it's hard to view success for the government as constituting elected officials' primary motivation. Instead, the most important thing is getting re-elected. That personal, short-term consideration can have nothing to do with the long-term well-being of the nation. This is especially true in the House of Representatives, he says, where two-year terms mean the members are never done running for re-election.

Despite the crisis facing the country and the crying need for prompt action, we're seeing a good dose of politics as usual. YouTube provides an up-close look at this stuff. It also gives politicians the audience many seem to crave.

Today a lynch-mob attitude prevails toward bankers, mortgage lenders and credit-rating agencies. I'm not saying a lot of it isn't deserved, but it still can be overdone. It's always good political theater to pile on a purported villain, whether through a perp-walk for handcuffed inside traders in 1986 or a televised congressional hearing for bankers in 2009.

Check out Congress's grilling of bankers on YouTube and you'll see what I think is vilification and *ad hominem* attack ("appealing to one's prejudices, emotions, or special

interests rather than to one's intellect or reason" – Random House Dictionary) intended for public consumption. One congressman told Vikram Pandit, Citibank's CEO, he was amazed by a deal the bank had made: "The government gets $7 billion in preferred stock and the government's on the hook for $250 billion of losses. . . . You tell me, Mr. Pandit: where can I get a deal like this?" Pandit explained that it was insurance: for a premium of $7 billion, Citibank got a policy covering $301 billion of mortgage securities, with Citi taking the first $30 billion of losses and 10% of any losses beyond that.

Should it come as a surprise that an insurance policy costs significantly less to buy than the amount of risk assumed by the insurer? If it didn't, why would anyone buy one? Under this policy, Citi will lose money if there aren't $38 billion in losses (in which case Citi would receive nothing on the first $30 billion but 90% of the next $8 billion, so proceeds would be equal to the $7 billion premium it had paid). Was this deal really such a giveaway? And should the Congressman really be surprised to learn the government has a preference for seeing Citi survive and is willing to cut it a good deal?

On the campaign trail and in victory, President Obama called for non-partisanship and united action. With Democrats controlling the White House and Congress, to him that means Republicans should vote in favor of solutions crafted primarily by Democrats. So far, it's not happening. On the stimulus package, only three of the 217 Republican votes in Congress – just over one percent – were cast with the Democratic majority. (And only seven of the 308 Democratic votes went with the Republicans.) Not much aisle crossing in either direction. Of course, there are lots of reasons why broad agreement is rarely seen:

- Genuine **ideological differences** exist between individuals and between parties. Some want an expanded government to fix problems, and others prefer to rely on free markets to do so. Some view increased government spending as holding the key to the solution, and others prefer to reduce taxes. Some want to rescue weak financial institutions, and others want only the strongest, best-run to survive. Thus, failing to go along with the majority isn't necessarily a sign of a character flaw.

- There are also valid **differences in motivation**. The president is a national officer whose job it is to find an overall solution. But legislators are elected locally to represent local interests, and those can diverge from the interests of other regions or the nation. It shouldn't come as a surprise that they push for particular benefits for their constituents.

- Finally there comes **self-interest**. The truth is that each party has the underlying goal of wanting to elect its members and make the other side look bad. And even if it's needed to solve a grave national problem, a conservative answer might be repugnant and unacceptable to voters in a liberal district, and vice versa. Thus, doing the "right thing" can be tantamount to political suicide. How many elected officials will choose the latter?

Today's Rhetoric

I think people in government who're addressing the situation have a difficult row to hoe:

- First and most immediately, they've had to play up the emergency in order to convince legislators (and the voters who put them in office) that the situation is dire and strong action is required. Thus we've heard words like "catastrophe," "collapse" and "worst since the Great Depression."

- Second, however, they're well advised to play down the threat. Franklin D. Roosevelt receives a lot of credit for having said, "The only thing we have to fear is fear itself." Given the crucial role of confidence in the functioning of an economy, it's not a great idea to spread panic. The rational response of frightened people is to save rather than spend, and to sell investments rather than buy, making things worse.

- Third, the President likely wants to create modest expectations. If there's a feeling that a valid response should work right away, slow progress will look like failure. No one wants consumers and businesses to further pull in their horns if economic recovery isn't forthcoming in 2009.

It's hard not to be sympathetic to this dilemma. It shows another of the ways in which conflicting goals have to be compromised in the real world of economics and politics.

The Bottom Line

There are so many moving parts to the current situation – and to its causes and what we hope will be its solution – that I've tried to boil things down to the essentials. **In order to right the system and get the economy moving forward again, I think three main things have to be accomplished:**

- **Our economy and its component parts have to be delevered;**
- **The vast destruction of capital has to be dealt with; and**
- **Confidence has to be restored.**

Here's how Paul Krugman described the challenge in *The New York Times* of February 16:

> For most of the last decade America was a nation of borrowers and spenders, not savers. . . .
>
> Yet until very recently Americans believed they were getting richer, because they received statements saying that their houses and stock portfolios were appreciating in value faster than their debts were increasing. . . .

> Then reality struck, and it turned out that the worriers had been right all along. The surge in asset values had been an illusion – but the surge in debt had been all too real. . . .
>
> . . . this is a broad-based mess. Everyone talks about the problems of the banks, which are indeed in even worse shape than the rest of the system. But the banks aren't the only players with too much debt and too few assets; the same description applies to the private sector as a whole.
>
> As the great American economist Irving Fisher pointed out in the 1930s, the things people and companies do when they realize they have too much debt tend to be self-defeating when everyone tries to do them at the same time. Attempts to sell assets and pay off debt deepen the plunge in asset prices, further reducing net worth. Attempts to save more translate into a collapse of consumer demand, deepening the economic slump.
>
> . . . Government officials understand the issue: we need to "contain what is a very damaging and potentially deflationary spiral," says Lawrence Summers, a top Obama economic adviser.

Debt has to be reduced, and it's happening (other than at the federal level, of course). But the way it happens is usually unpleasant: bankruptcies, foreclosures and debt restructurings. **"Debt reduction" sounds like a good thing, but it's likely to be accompanied by the painful loss of the assets that had been bought with borrowed money.**

Many assets are worth far less than they used to be – that's one of the main reasons why the debt load has become unbearable and has to be reduced. **Investors, consumers, homeowners and financial institutions will have to rebuild their capital as they – and the economy – attempt to again move ahead.**

And confidence has to be rebuilt, too. **The willingness to borrow, spend and invest will rebound only when people believe incomes and asset values will resume their growth.**

In the past, we've seen a standard pattern unfold, with the best examples falling in the corporate debt arena. **Once denial ends and people accept capital destruction as a fact, restructurings can take place in which debt is discharged and ownership changes hands. The transition of assets to new owners, who may have lower cost bases and the ability to inject additional capital, brings the possibility of attractive returns, the onset of which restores interest in investing. It seems inescapable that this pattern will be a major feature of the next few years.**

The government's actions clearly are aimed at accomplishing the three things I say we need. Some will work, and some won't. **I believe that, eventually, the combination of things they try – along with the pattern described above and the positive bent that**

underlies the free market system – will return us to an upward trajectory. It just won't be easy, quick or painless.

And that's why I think the investment decisions we make today must emphasize value, survivability and staying power. I readily acknowledge that assuring survival in bad times is inconsistent with return maximization in good times. Insistence on these three things won't produce the greatest rewards if the economy and markets surprise on the upside, but that's not my main concern.

Given the uncertainty present today, it's hard enough to find investments that can be relied on to deliver solid returns in good times but also assure survival in bad. **In that interest, we've always been willing to cede to others much of that part of the return distribution lying between "solid" and "maximum." This time is no different.**

March 5, 2009

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Memo to: Oaktree Clients

From: Howard Marks

Re: So Much That's False and Nutty

As reported in *The New York Times* of May 5, Warren Buffett told the crowd at this year's Berkshire Hathaway annual meeting:

> There is so much that's false and nutty in modern investing practice and modern investment banking. If you just reduced the nonsense, that's a goal you should reasonably hope for.

As we look back at the causes of the crisis approaching its second anniversary – and ahead to how investors might conduct themselves better in the future – Buffett's simple, homespun advice holds the key, as usual. I agree that investing practice went off the rails in several fundamental ways. Perhaps this memo can help get it back on.

<u>The Lead-up: Progress and Missteps</u>

Memory dims with the passage of time, but when I think back to the investment arena I entered forty-plus years ago, it seems very different from that of 2003-07. Institutional investing was done mainly by bank investment departments (like the one I was part of), insurance companies and investment counselors – a pretty dull bunch. And as I like to point out when I speak to business school classes, "famous investor" was an oxymoron – few investment managers were well known, chosen for magazine covers or listed among the top earners.

There were no swaps, index futures or listed options. Leverage wasn't part of most institutional investors' arsenal . . . or vocabulary. Private equity was unknown, and hedge funds were too few and outré to matter. Innovations like quantitative investing and structured products had yet to arrive, and few people had ever heard of "alpha."

Return aspirations were modest. Part of this likely was attributable to the narrow range of available options: for the most part stocks and bonds. Stocks would average 9-10% per year, it was held, but we might put together a portfolio that would do a little better. And the admissible bonds were all investment grade, yielding moderate single digits.

We wanted to earn a good return, limit the risks, beat the Dow and our competitors, and retain our clients. But I don't remember any talk of "maximization," or anyone trying to "shoot the lights out." And by the way, no one had ever heard of performance fees. Quite a different world from that of today. Perhaps it would constitute a service if I pulled together a list of some of the developments since then:

- In the mid-1960s, **growth investing** was invented, along with the belief that if you bought the stocks of the "nifty-fifty" fastest-growing companies, you didn't have to worry about paying the right price.
- The first of the **investment boutiques** was created in 1969, as I recall, when highly respected portfolio managers from a number of traditional firms joined together to form Jennison Associates. For the first time, institutional investing was sexy.
- We started to hear more about **investment personalities**. There were the "Oscars" (Schafer and Tang) and the "Freds" (Carr, Mates and Alger) – big personalities with big performance, often working outside the institutional mainstream.
- In the early 1970s, **modern portfolio theory** began to seep from the University of Chicago to Wall Street. With it came indexation, risk-adjusted returns, efficient frontiers and risk/return optimization.
- Around 1973, put and call **options** escaped from obscurity and began to trade on exchanges like the Chicago Board Options Exchange.
- Given options' widely varying time frames, strike prices and underlying stocks, a tool for valuing them was required, and the **Black-Scholes model** filled the bill.
- A small number of **leveraged buyouts** took place starting in the mid-1970s, but they attracted little attention.
- 1977-79 saw the birth of the **high yield bond market**. Up to that time, bonds rated below investment grade couldn't be issued. That changed with the spread of the argument – associated primarily with Michael Milken – that incremental credit risk could responsibly be borne if offset by more-than-commensurate yield spreads.
- Around 1980, **debt securitization** began to occur, with packages of mortgages sliced into securities of varying risk and return, with the highest-priority tranche carrying the lowest yield, and so forth. This process was an example of disintermediation, in which the making of loans moved out of the banks; 25 years later, this would be called the **shadow banking system.**
- One of the first "quant" miracles came along in the 1980s: **portfolio insurance**. Under this automated strategy, investors could ride stocks up but avoid losses by entering stop-loss orders if they fell. It looked good on paper, but it failed on Black Monday in 1987 when brokers didn't answer their phones.
- In the mid- to late 1980s, the ability to borrow large amounts of money through high yield bond offerings made it possible for minor players to effect buyouts of large, iconic companies, and "**leverage**" became part of investors' everyday vocabulary.
- When many of those buyouts proved too highly levered to get through the 1990 recession and went bust, investing in **distressed debt** gained currency.
- Real estate had boomed because of excessive tax incentives and the admission of real estate to the portfolios of S&Ls, but it collapsed in 1991-92. When the Resolution Trust Corporation took failed properties from S&Ls and sold them off, **"opportunistic" real estate** investing was born.
- Mainstream investment managers made the big time, with Peter Lynch and Warren Buffett becoming famous for consistently beating the equity indices.
- In the 1990s, **emerging market investing** became the hot new thing, wowing people until it took its knocks in the mid- to late 1990s due to the Mexican peso devaluation, Asian financial crisis and Russian debt disavowal.

- **Quant investing** arrived, too, achieving its first real fame with the success of Long-Term Capital Management. This Nobel Prize-laden firm used computer models to identify fixed income arbitrage opportunities. Like most other investment miracles, it worked until it didn't. Thanks to its use of enormous leverage, LTCM melted down spectacularly in 1998.
- Investors' real interest in the last half of the '90s was in **common stocks,** with the frenzy accelerating but narrowing to **tech-media-telecom stocks** around 1997 and narrowing further to **Internet stocks** in 1999. The "limitless potential" of these instruments was debunked in 2000, and the equity market went into its first three-year decline since the Great Crash of '29.
- **Venture capital funds**, blessed with triple-digit returns thanks to the fevered appetite for tech stocks, soared in the late 1990s and crashed soon thereafter.
- After their three-year slump, the loss of faith in common stocks caused investors to shift their hopes to **hedge funds** – "absolute return" vehicles expected to make money regardless of what went on in the world.
- With the bifurcation of strategies and managers into "beta-based" (market-driven) and "alpha-based" (skill-driven), investors concluded they could identify managers capable of **alpha investing**, emphasize it, perhaps synthesize it, and "port" or carry it to their portfolios in additive combinations.
- **Private equity** – sporting a new label free from the unpleasant history of "leveraged buyouts" – became another popular alternative to traditional stocks and bonds, and funds of $20 billion and more were raised at the apex in 2006-07.
- Wall Street came forward with a plan to package prosaic, reliable home mortgages into **collateralized debt obligations** – the next high-return, low-risk free lunch – with help from tranching, securitization and selling onward.
- The key to the purported success of this latest miracle lay in **computer modeling**. It quantified the risk, assuming that mortgage defaults would remain uncorrelated and benign as historically had been the case. But because careless mortgage lending practices unknowingly had altered the probabilities, the default experience turned out to be much worse than the models suggested or the modelers thought possible.
- Issuers of **collateralized loan obligations** bought corporate loans using the same processes that had been applied to CDOs. Their buying facilitated vast issuance of syndicated bank loans carrying low interest rates and few protective covenants, now called **leveraged loans** because the lending banks promptly sold off the majority.
- Options were joined by futures and swaps under a new heading: **derivatives**. Heralded for their ability to de-risk the financial system by shifting risk to those best able to bear it, derivatives led to vast losses and something new: counterparty risk.
- The common thread running through hedge funds, private equity funds and many other of these investment innovations was **incentive compensation**. Expected to align the interests of investment managers and their clients, in many cases it encouraged excessive risk taking.
- Computer modeling was further harnessed to create **"value at risk"** and other risk management tools designed to quantify how much would be lost if the investment environment soured. This fooled people into thinking risk was under control – a belief that, if acted on, has the potential to vastly increase risk.

At the end of this progression we find an institutional investing world that bears little resemblance to the quaint cottage industry with which the chronology began more than forty years ago. Many of the developments served to increase risk or had other negative implications, for investors individually and for the economy overall. In the remainder of this memo, I'll discuss these trends and their ramifications.

Something for Everyone

One thing that caused a lot of people to lose money in the crisis was the popularization of investing. Over the last few decades, as I described in "The Long View" (January 2009), investing became widespread. "Less than 10% of adults owned stocks in the 1950s, in contrast to 40% today." (*Economics and Portfolio Strategy*, June 1, 2009). Star investors became household names and were venerated. "How-to" books were big sellers, and investors graced the covers of magazines. Television networks were created to cover investing 24/7, and Jim Cramer and the "Money Honey" became celebrities in their own right.

It's interesting to consider whether this "democratization" of investing represented progress, because in things requiring special skill, it's not necessarily a plus when people conclude they can do them unaided. The popularization – with a big push from brokerage firms looking for business and media hungry for customers – was based on success stories, and it convinced people that "anyone can do it." **Not only did this overstate the ease of investing, but it also vastly understated the danger**. ("Risk" has become such an everyday word that it sounds harmless – as in "the risk of underperformance" and "risk-adjusted performance." Maybe we should switch to "danger" to remind people what's really involved.)

To illustrate, I tend to pick on Wharton Professor Jeremy Siegel and his popular book "Stocks for the Long Run." Siegel's research was encyclopedic and supported some dramatic conclusions, perhaps foremost among them his showing that there's never been a 30-year period in which stocks didn't outperform cash, bonds and inflation. This convinced a lot of people to invest heavily in stocks. But even if his long-term premise eventually holds true, anyone who invested in the S&P 500 ten years ago – and is now down 20% – has learned that 30 years can be a long time to wait.

The point is that not everyone is suited to manage his or her own investments, and not everyone should take on uncertain investments. The success of Bernard Madoff's Ponzi scheme shows that even people who are wealthy and presumed sophisticated can overlook risks. Might that be borne in mind the next time around?

At Ease with Risk

Risk is something every investor should think about constantly. We know we can't expect to make money without taking chances. The reason's simple: if there was a risk-

free way to make good money – that is, a path to profit free from downside – everyone would pursue it without hesitation. That would bid up the price, bring down the return and introduce the risk that accompanies elevated prices.

So yes, it's true that investors can't expect to make much money without taking risk. But that's not the same as saying risk taking is sure to make you money. As I said in "Risk" (January 2006), if risky investments always produced high returns, they wouldn't be risky.

The extra return we hope to earn for holding stocks rather than bonds is called an equity risk premium. The additional promised yield on high yield bonds relative to Treasurys is called a credit risk premium. All along the upward-sloping capital market line, the increase in potential return represents compensation for bearing incremental risk. Except for those people who can generate "alpha" or access alpha managers, investors shouldn't plan on getting added return without bearing incremental risk. And for doing so, they should demand risk premiums.

But at some point in the swing of the pendulum, people usually forget that truth and embrace risk taking to excess. In short, in bull markets – usually when things have been going well for a while – people tend to say, "Risk is my friend. The more risk I take, the greater my return will be. I'd like more risk, please."

The truth is, risk tolerance is antithetical to successful investing. When people aren't afraid of risk, they'll accept risk without being compensated for doing so . . . and risk compensation will disappear. This is a simple and inevitable relationship. When investors are unworried and risk-tolerant, they buy stocks at high p/e ratios and private companies at high EBITDA multiples, and they pile into bonds despite narrow yield spreads and into real estate at minimal "cap rates."

In the years leading up to the current crisis, it was "as plain as the nose on your face" that prospective returns were low and risk was high. In simple terms, there was too much money looking for a home, and too little risk aversion. Valuation parameters rose and prospective returns fell, and yet the amount of money available to managers grew steadily. Investors were attracted to risky deals, complex structures, innovative transactions and leveraged instruments. In each case, they seemed to accept the upside potential and ignore the downside.

There are few things as risky as the widespread belief that there's no risk, because it's only when investors are suitably risk-averse that prospective returns will incorporate appropriate risk premiums. Hopefully in the future (a) investors will remember to fear risk and demand risk premiums and (b) we'll continue to be alert for times when they don't.

Embracing Illiquidity

Among the risks faced by the holder of an investment is the chance that if liquidity has dried up at a time when it has to be sold, he'll end up getting paid less than it's worth. **Illiquidity is nothing but another source of risk, and it should be treated no differently**:

- All else being equal, investors should prefer liquid investments and dislike illiquidity.
- Thus, before making illiquid investments, investors should ascertain that they're being rewarded for bearing that risk with a sufficient return premium.
- Finally, out of basic prudence, investors should limit the proportion of their portfolios committed to illiquid investments. There are some risks investors shouldn't take regardless of the return offered.

But just as people can think of risk as a plus, so can they be attracted to illiquidity, and for basically the same reason. There is something called an illiquidity premium. It's the return increment investors should receive in exchange for accepting illiquidity. But it'll only exist if investors prefer liquidity. If they're indifferent, the premium won't be there.

Part of the accepted wisdom of the pre-crisis years was that long-term institutional investors should load up on illiquid investments, capitalizing on their ability to be patient by garnering illiquidity premiums. In 2003-07, so many investors adopted this approach that illiquidity premiums became endangered. For example, as of the middle of 2008, the average $1 billion-plus endowment is said to have had investments in and undrawn commitments to the main illiquid asset classes (private equity, real estate and natural resources) equal to half its net worth. Some had close to 90%.

The willingness to invest in locked-up private investment funds is based on a number of "shoulds." Illiquid investments should deliver correspondingly higher returns. Closed-end investment funds should call down capital gradually. Cash distributions should be forthcoming from some funds, enabling investors to meet capital calls from others. And a secondary market should facilitate the sale of positions in illiquid funds, if needed, at moderate discounts from their fair value. But things that should happen often fail to happen. That's why investors should view potential premium returns skeptically and limit the risk they bear, including illiquidity.

Comfortable with Complexity

Investors' desire to earn money makes them willing to do things they haven't done before, especially if those things seem modern and sophisticated. Technological complexity and higher math can be seductive in and of themselves. And good times and rising markets encourage experimentation and erase skepticism. These factors allow Wall Street to sell innovative products in bull markets (and only in bull markets). But these innovations can be tested only in bear markets . . . and invariably they are.

Many of the investment techniques that were embraced in 2003-07 represented quantitative innovations, and people seemed to think of that as an advantage rather than a source of potential risk. Investors were attracted to black-box quant funds, highly levered mortgage securities critically dependent on computer models, alchemical portable alpha, and risk management based on sketchy historical data. The dependability of these things was shaky, but the risks were glossed over. As Alan Greenspan wrote in *The Wall Street Journal* of March 11:

> It is now very clear that the levels of complexity to which market practitioners at the height of their euphoria tried to push risk-management techniques and products were too much for even the most sophisticated market players to handle properly and prudently.

Warren Buffett put it in simpler terms at this year's Berkshire meeting. "**If you need a computer or a calculator to make the calculation, you shouldn't buy it**." And Charlie Munger added his own slant: "Some of the worst business decisions I've ever seen are those with future projections and discounts back. It seems like the higher mathematics with more false precision should help you, but it doesn't. They teach that in business schools because, well, they've got to do something."

To close on this subject, I want to share a quote I recently came across from Albert Einstein. I've often argued that the key to successful investing lies in subjective judgments made by experienced, insightful professionals, not machinable processes, decision rules and algorithms. I love the way Einstein put it:

> **Not everything that can be counted counts, and not everything that counts can be counted.**

Relying on Ratings

My memos on the reasons for the crisis, like "Whodunit" (February 2008), show that there's more than enough blame to go around and lots of causes to cite. **But if you boil it down, there was one indispensable ingredient in the process that led to trillions of dollars of losses: misplaced trust in credit ratings.** The explanation is simple:

- Competitive pressure for profits caused financial institutions to try to keep up with the leaders. As is normal in good times, the profit leaders were those who used the most leverage.
- Thus institutions sought to maximize their leverage, but the rules required that the greatest leverage be used only with investments rated triple-A.
- A handful of credit rating agencies had been designated by the government as Nationally Recognized Statistical Rating Organizations, despite their highly imperfect track records.
- The people who guard the financial henhouse often have a tough time keeping up with the foxes' innovations. Whereas traditional bond analysis was a relatively

simple matter, derivatives and tiered securitizations were much more complex. This allowed rating agency employees to be manipulated by the investment banks' quantitatively sophisticated and highly compensated financial engineers.

- The rating agencies proved too naïve, inept and/or venal to handle their assigned task.
- Nevertheless, **financial institutions took the ratings at face value, enabling them to pursue the promise of highly superior returns from supposedly riskless, levered-up mortgage instruments. This deal clearly was too good to be true, but the institutions leapt in anyway.**

It all started with those triple-A ratings. For his graduation from college this year, Andrew Marks wrote an insightful thesis on the behavior that gave rise to the credit crisis. I was pleased that he borrowed an idea from "Whodunit": "if it's possible to start with 100 pounds of hamburger and end up selling ten pounds of dog food, 40 pounds of sirloin and 50 pounds of filet mignon, the truth-in-labeling rules can't be working." That's exactly what happened when mortgage-related securities were rated.

Investment banks took piles of residential mortgages – many of them subprime – and turned them into residential mortgage-backed securities (RMBS). The fact that other tranches were subordinated and would lose first allowed the rating agencies to be cajoled into rating a lot of RMBS investment grade. Then RMBS were assembled into collateralized debt obligations, with the same process repeated. In the end, heaps of mortgages – each of which was risky – were turned into CDO debt, more than 90% of which was rated triple-A, meaning it was supposed to be almost risk-free.

John Maynard Keynes said ". . . a speculator is one who runs risks of which he is aware and an investor is one who runs risks of which he is unaware." Speculators who bought the low end of the CDO barrel with their eyes open to the risk suffered total losses on a small part of their capital. But the highly levered, esteemed investing institutions that accepted the higher ratings without questioning the mortgage alchemy lost large amounts of capital, because of the ease with which they'd been able to lever holdings of triple-A and "super-senior" CDOs. Ronald Reagan said of arms treaties, "Trust, then verify." If only financial institutions had done the same.

The rating agencies were diverted from their mission by a business model that made them dependent on security issuers for their revenues. This eliminated their objectivity and co-opted them into the rating-maximization process. Regardless of that happening, however, it's clear that the stability of our financial institutions never should have been allowed to rely so heavily on the competence of a few for-profit (and far-from-perfect) rating agencies. **In the future, when people reviewing the crisis say, "If only they had . . . ," the subject will often be credit ratings. Bottom line: investors must never again abdicate the essential task of assessing risk. It's their number-one job to perform thorough, skeptical analysis.**

The More You Bet . . .

If I had to choose a single phrase to sum up investor attitudes in 2003-07, it would be the old Las Vegas motto: "The more you bet, the more you win when you win." Casino profits ride on getting people to bet more. In the financial markets just before the crisis, players needed no such encouragement. They wanted to bet more, and the availability of leverage helped them do so.

One of the major trends embedded in the chronology on pages two and three was toward increasing the availability of leverage. Now, I've never heard of any of Oaktree's institutional clients buying on margin or taking out a loan to make investments. It might not be considered "normal" for fiduciaries, and tax-exempt investors would have to worry about Unrelated Business Taxable Income.

None of us go out and buy Intel chips, but we've all seen commercials designed to get us to buy products with "Intel inside." In the same way, **investors became increasingly able to buy investment products with leverage inside . . . that is, to participate in levered strategies rather than borrow explicitly to make investments**. Think about these elements from my earlier list of investment developments:

- Investors who would never buy stocks on margin were able to invest in private equity funds that would buy companies on leverage of four times or more.
- The delayed and irregular nature of drawdowns caused people who had earmarked $100 for private investment funds to make commitments totaling $140.
- Options, swaps and futures – in fact, many derivatives – are nothing but ways for investors to access the return on large amounts of assets with little money down.
- Many hedge funds used borrowings or derivatives to access the returns on more assets than their capital would allow them to buy.
- When people wanted to invest $100 in markets with skill-derived return bolted on, "portable alpha" had them invest $90 in hedge funds with perceived alpha and the rest in futures covering $100 worth of the passive market index. This gave them a stake in the performance of $190 of assets for every $100 of capital.

Clearly, each of these techniques exposed investors to the gains or losses on increased amounts of assets. If that's not leverage, what is? In fact, an article entitled "Harvard Endowment Chief Is Earning Degree in Crisis Management" in *The New York Times* of February 21 said of Harvard, "The endowment was squeezed partly because **it had invested more than its assets** . . ." (emphasis added). I find this statement quite remarkable, and yet no one has remarked on it to me.

It shouldn't be surprising that people engaging in these levered strategies made more than others when the market rose. But 2008 showed the flip side of that equation in action. **In the future, investors should consider whether they really want to lever their capital or just invest the amount they have**.

Sharing the Wealth

Apart from the increasing use of leverage, another trend that characterized the five years before the crisis was the widespread imposition of incentive fees.

In the 1960s, at the start of my chronology, only hedge funds commanded incentive fees, and there were too few for most people to know or care about. But fee arrangements that can be simplified as "two-and-twenty" flowered with private equity in the 1980s, distressed debt, opportunistic real estate and venture capital funds in the 1990s, and hedge funds in the 2000s. Soon they were everyplace.

Here are my basic thoughts on this sort of arrangement. (Oaktree receives incentive compensation on roughly half its assets; my objection isn't with regard to the fees themselves, but rather the way they've been applied.)

- **It seems obvious that incentive fees should go only to managers with the skill needed to add enough to returns to more than offset the fees – other than through the mere assumption of incremental risk.** For example, after a high yield bond manager's .50% fee, a 12% gross return becomes 11.5% net. A credit hedge fund charging a 2% management fee and 20% of the profits would have to earn a 16.375% gross return to net 11.5%. That's 36% more return. **How many managers in a given asset class can generate this incremental 36% other than through an increase in risk? A few? Perhaps. The majority? Never.**

- **Thus, incentive fee arrangements should be exceptional, but they're not**. These fees didn't go to just the proven managers (or the ones whose returns came from skill rather than beta); they went to everyone. If you raised your hand in 2003-07 and said "I'm a hedge fund manager," you got a few billion to manage at two-and-twenty, even if you didn't have a record of successfully managing money over periods that included tough times.

- The run-of-the-mill manager's ease of obtaining incentive fees was enhanced each time a top manager capped a fund. As I wrote in "Safety First . . . But Where?" (April 2001), "When the best are closed, the rest will get funded."

- In fact, whereas two-and-twenty was unheard-of in the old days, it became the norm in 2003-07. This enabled a handful of managers with truly outstanding records to demand profit shares ranging up to 50%.

- Clients erred in using the term "alignment of interests" to describe the effect of incentive compensation on their relationships with managers. Allowing managers to share in the upside can bring forth best efforts, but it can also encourage risk bearing instead of risk consciousness. Most managers just don't have enough money to invest in their funds such that loss of it could fully balance their potential fees and upside participation. **Instead of alignment, then, incentive compensation must be viewed**

largely as a "heads we win; tails you lose" arrangement. Clearly, it must be accorded only to the few managers who can be trusted with it.

- **Finally, the responsibility for overpaying doesn't lie with the person who asks for excessive compensation, but rather with the one who pays it.** How many potential LPs ever said, "He may be a great manager, but he's not worth that fee." I think most applied little price discipline, as they were driven by the need to fill asset class allocations and/or the fear that if they said no, they might miss out on a good thing (more on this subject later).

I'm asked all the time nowadays what I expect to happen with investment manager compensation. First, I remind people that what should happen and what will happen are two different things. Then I make my main point: there should be much more differentiation. **Whereas in past years everyone's fees were generous and pretty much the same, the post-2007 period is providing an acid test that will show who helped their clients and who didn't.** Appropriate compensation adjustments should follow.

Managers who actually helped their clients before and during this difficult period – few in number, I think – will deserve to be very well compensated, and their services could be in strong demand. The rest should receive smaller fees or be denied incentive arrangements, and some might turn to other lines of work. Oaktree hopes to be among the former group. We'll see.

Ducking Responsibility

The inputs used by a business to make its products are its costs. The money it receives for its output are its revenues. The difference between revenues and costs are its profits. At the University of Chicago, I was taught that by maximizing profits – that is, maximizing the excess of output over input – a company maximizes its contribution to society. This is among the notions that have been dispelled, exposing the imperfections of the free-market system. (Hold on; I'm not saying it's a bad system, just not perfect.)

When profit maximization is exalted to excess, ethics and responsibility can go into decline, a phenomenon that played a substantial role in getting us where we are. The pursuit of short-term profit can lead to actions that are counterproductive for others, for society and for the long run. For example:

- A money manager's desire to add to assets under management, and thus profits, can lead him to take in all the money he can. But when asset prices and risks are high and prospective returns are low, this clearly isn't good for his clients.
- Selling financial products to anyone who'll buy them, as opposed to those for whom they're right, can put investors at unnecessary risk.
- And cajoling rating agencies into assigning the highest rating to debt backed by questionable collateral can put whole economies in jeopardy, as we've seen.

One of the concepts that governed my early years, but about which I've heard little in recent years, is "fiduciary duty." Fiduciary duty is the obligation to look out for the welfare of others, as opposed to maximizing for yourself. It can be driven by ethics or by fear of legal consequences; either way, it tends to cause caution to be emphasized.

When considering a course of action, we should ask, "Is it right?" Not necessarily the cleverest practice or the most profitable, but the right thing? The people I think of perverting the mortgage securitization process never wondered whether they were getting an appropriate rating, but whether it was the highest possible. Not whether they were doing the right thing for clients or society, but whether they were wringing maximum proceeds out of a pile of mortgage collateral and thus maximizing profits for their employers and bonuses for themselves.

A lot of misdeeds have been blamed on excessive emphasis on short-term results in setting compensation. The more compensation stresses the long run, the more it creates big-picture benefits. Long-term profits do more good – for companies, for business overall and for society – than does short-term self-interest.

Focusing on the Wrong Risk

The more I've thought about it over the last few months, the more I've concluded that investors face two main risks: (1) the risk of losing money and (2) the risk of missing opportunity. Investors can eliminate one or the other, but not both. More commonly, they must consider how to balance the two. How they do so will have a great impact on their results. This is the old dilemma – fear or greed? – that people talk about so much. It's part of the choice between offense and defense that I often stress (see, for example, "What's Your Game Plan?" September 2003).

The problem is that investors often fail to strike an appropriate balance between the two risks. In a pattern that exemplifies the swing of the pendulum from optimistic to pessimistic and back, investors regularly oscillate between extremes at which they consider one to the exclusion of the other, not a mixture of the two.

One of the ways I try to get a sense for what's going on is by imagining the conversations investors are having with each other . . . or with themselves. In 2003-07, with most investors worried only about achieving returns, I think the conversation went like this: "I'd better not make less than my peers. Am I behaving as aggressively as I should? Am I using as much leverage as my competitor? Have I shifted enough from stocks and bonds to alternatives, or am I being an old fogey? If my commitments to private equity are 140% of the amount I actually want to invest, is that enough, or should I do more?"

Few people seemed to worry about losses. Or if they were worried, they played anyway, fearing that if they didn't, they'd be left behind. That must be what drove Citigroup's Chuck Prince when he said, "as long as the music's playing, you've got to get up and

dance. We're still dancing." **The implication's clear: No worries; high prices. No risk aversion; no risk premiums**. Certainly that describes the markets in 2003-07.

In the fourth quarter of 2008, when asset prices were collapsing, I imagined a very different conversation from that of 2003-07, with most investors saying, "I don't care if I never make another dollar in the market; I just don't want to lose any more. Get me out!" Attitudes toward the two risks were still unbalanced, but in the opposite direction.

Just as risk premiums disappear when risk is ignored, so can prospective returns soar when risk aversion is excessive. In late 2008, economic fundamentals were terrible; technical conditions consisted of forced selling and an absence of buyers; and market psychology melted down. Risk aversion predominated, and fear of missing out disappeared. These are the conditions under which assets are most likely to be available for purchase at prices way below their fair value. They're also the conditions in which most people go on buying strikes.

In the future, investors should do a better job of balancing the fear of losing money and the fear of missing out. My response is simple: Good luck with that.

Pursuing Maximization

When markets are rising and investors are obsessed with the fear of missing out, the desire is for maximum returns. Here's the inner conversation I imagine: "I need a return of 8% a year. But I'd rather have 10%. 14% would be great, and the possibility of 16% warrants adding to my risk. It's worth using leverage for a shot at 20%, and with twice as much leverage, I might get 24%."

In other words, more is better. And of course it is . . . except that to pursue higher returns, you have to give up something. That something is safety. But in hot times, no one worries about losing money, just missing out. So they try to maximize.

There should be a point at which investors say, "I need 8%, and it would be great if I could get 16%. But to try, I would have to do things that expose me to excessive loss. I'll settle for a safer 10% instead." **I've labeled this concept "good-enough returns**." **It's based on the belief that the possibility of more isn't always better. There should be a point at which investors decline to take more risk in the pursuit of more return, because they're satisfied with the return they expect and would rather achieve that with high confidence than try for more at the risk of falling short (or losing money).**

Most investors will probably say that in 2003-07, they didn't blindly pursue maximization; it was the other guys. But someone did it, and we're living with the consequences. **I like it better when society balances risk and return rather than trying to maximize. Less gain, perhaps, but also less pain.**

*   *   *

"Apropos of nothing," as my mother used to say, I'm going to use the opportunity provided by this memo to discuss market conditions and the outlook. On the plus side:

- We've heard a lot recently about "green shoots": mostly cases where things have stopped getting worse or the rate of decline is slowing. A few areas have shown actual improvement, such as consumer confidence and durable goods orders. It's important when you consider these improvements, however, to bear in mind that when you get deep into a recession, the comparisons are against depressed periods, and thus easier.
- It's heartening to see the capital markets open again, such that banks can recapitalize and borrowers can extend maturities and delever. Noteworthily, Michael Milken and Jonathan Simons wrote in *The Wall Street Journal* of June 20 that, "Global corporations have raised nearly $2 trillion in public and private markets this year . . ."
- Investor opinion regarding markets and the government's actions has grown more positive, and as Bruce Karsh says, "Armageddon is off the table." (He and I both felt 6-9 months ago that a financial system meltdown absolutely couldn't be ruled out.)

These positives are significant, but there also are many unresolved negatives:

- Business is still terrible. Sales trends are poor. Where profits are up, it's often due to cost-cutting, not growth. (Remember, one man's economy measure is another's job loss – not always a plus for the overall picture.)
- Unemployment is still rising, and with incomes shrinking, savings rising as a percentage of shrinking incomes, and credit scarcer, it's hard to see whose spending will power a recovery.
- The outlook for residential and, particularly, commercial real estate remains poor, with implications for further write-offs on the part of the banks. Ditto for credit card receivables.
- Many companies are likely to experience debt refinancing challenges, defaults, bankruptcies and restructurings.
- Developments such as rising interest rates and rising oil prices have the power to impede a recovery.
- Finally, no one can say with confidence what will be the big-picture ramifications of trillions of dollars of federal deficit spending, or the states' fiscal crises.

I'm not predicting that these things will turn out badly, merely citing potential negatives that may not be fully reflected in today's higher asset prices. My greatest concern surrounds the fact that we're in the middle of an unprecedented crisis, brought on by never-seen-before financial behavior, against which novel remedies are being attempted. And yet many people seem confident that a business-as-usual recovery lies ahead. They're applying normal lag times and extrapolating normal decline/recovery relationships. **The words of the late Amos Tversky aptly represent my view: "It's frightening to think that you might not know something, but more frightening to**

think that, by and large, the world is run by people who have faith that they know exactly what's going on."

Peter Bernstein, a towering intellect who sadly passed away a month ago, made some important contributions to the way I think about investing. Perhaps foremost among them was his trenchant observation that, "Risk means more things can happen than will happen." **Investors today may think they know what lies ahead, but they should at least acknowledge that risk is high, the range of possibilities is wider than it was ever thought to be, and there are a few that could be particularly unpleasant.**

Unlike 2003-07 when no one worried about risk, or late 2008 when few investors cared about opportunity, the two seem to be in better balance given the revival of risk taking this year. Thus the markets have recovered, with most of them up 30% or more from their bottoms (debt in December and stocks in March).

If you and I had spoken six months ago, we might have reflected on the significant stock market rallies that occurred during the decade-long Great Depression, including a 67% gain in the Dow in 1933. How uncalled-for those rallies appear in retrospect. But now we've had one of our own.

Clearly, improved psychology and risk tolerance have played a big part in the recent rally. These things have strengthened even as economic fundamentals haven't, and that could be worrisome. (On June 23, talking about general resilience – not investor attitudes – President Obama said the American people ". . .are still more optimistic than the facts alone would justify.") On the other hand, there's good reason to believe that at their lows, security prices had understated the merits. So are prices ahead of fundamentals today, or have they merely recovered from "too low" to "in balance"? There's no way to know for sure.

Unlike the fourth quarter of last year – when assets were depressed by terrible fundamentals, technicals and psychology – they're no longer at giveaway prices. Neither are they clearly overvalued. Maybe we should say "closer to fair."

With price and value in reasonable balance, the course of security prices will largely be determined by future economic developments that defy prediction. Thus I find it hard to be highly opinionated at this juncture. Few things are compelling sells here, but I wouldn't be a pedal-to-the-metal buyer either. On balance, I think better buying opportunities lie ahead.

July 8, 2009

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