

Memo to: Oaktree Clients

From: Howard Marks

Re: Oaktree at Ten

Oaktree Capital Management, LLC opened its doors ten years ago, on April 10, 1995. That day represented a first step toward the founders' dream, which all of our colleagues embraced and implemented. In what truly feels like the blink of an eye, we've reached our tenth anniversary, and I'm writing to share our view of that first decade.

Priorities – Oaktree didn't start with a budget, a profit projection or a business plan. Rather, it was built on an investment philosophy and a set of business principles. When we started Oaktree, many people asked us about our motivation. We told them it was simple: we wanted a firm that would run our way. The things that constituted "our way" had been rattling around in our heads for many years and were the topic of many shared conversations. All that remained was to write them down and put them to work.

As you've heard *ad nauseum*, we chose to base Oaktree's approach to money management on a simple motto: "if we avoid the losers, the winners will take care of themselves." Thus we've endeavored to build portfolios that would give us acceptable performance if our expectations weren't fully realized, combined with the possibility of surprises on the upside if they were. We've strived to match market returns in good times and do markedly better in bad times – something that may sound simple but isn't. We chose to work in inefficient markets only, with portfolios that stick closely to their charter. Each of our portfolios is staffed by people dedicated to that market sector – who work hard to know more than others about companies, industries and securities, and who realize they can't get an edge with regard to macro forecasts and market timing. Thus our investment philosophy has provided a clear set of guideposts for Oaktree's people.

Equally important have been our business practices. Here the concepts are even simpler, but no less helpful: Portfolio decisions based on substantial investment in proprietary research. Conflicts of interest resolved in favor of the client every time. Compensation arrangements that align our interests with those of our clients. Thoroughly truthful communications and a pronounced refusal to downplay bad news. New strategies added only if they can be executed with risk under control. In 1995, we wrote that "The firm's profitability must stem from doing all the above. . . . Our earnings should grow if we achieve excellence in investing . . . but only then." We've all seen instances in recent years when gathering assets was accorded a higher priority than performing for clients – and headlines that were sad testimony to the result. I'm proud to say Oaktree's single-minded pursuit of its clients' interests has never been questioned.

We published our guiding principles in the spring of 1995 and literally haven't changed a word since (other than to add the criteria for new Oaktree strategies). And as we head into the second decade, we consider them just as applicable to the future as they have been in the past.

Clients – We felt going in that if we stuck to the rules we’d followed previously and delivered the same level of performance, the rest would come: we’d have a successful business on our hands. Happily, that’s what happened.

We are thrilled by the caliber of the investors we’re able to call our clients – the term “gilt-edge” seems inescapable: Twenty-four of the fifty largest corporate pension plans as of year-end 2004. The pension funds of twenty-two of the fifty states (plus many counties, cities and police and fire departments). Eighty-one college and university endowments. Many of the world’s leading charitable foundations and most sophisticated insurers. A Vanguard mutual fund. And a growing complement of high net worth investors. Here’s a fact for you: of the 25 pension plans with the biggest commitments to distressed debt according to Pensions & Investments, (a good indicator of investment sophistication, we think), 23 participate in at least one Oaktree strategy. Oaktree’s client roster represents the ultimate validation of our efforts as investment professionals. And it expands every year. In fact, we feel most ten-year-old money management firms would be happy to have a clientele consisting of just the accounts that join Oaktree in a typical year.

Even more important than the number of our clients is the quality of the relationships. Many have become true partners who extend a warm welcome, give our proposals the benefit of the doubt, believe us when we say something is true, provide their valuable counsel, and continue to broaden the list of things they do with us. As a result, on average our twenty largest client relationships encompass more than four of Oaktree’s twelve strategies. The reception we receive from our clients is truly one of our greatest sources of satisfaction.

Performance – Of course, we realize that these relationships stem only in part from the fact that our clients like us as people or share our philosophy. We’d be no place without performance. Thus we’re proud to be able to say we’ve achieved what we set out to do. We’d love to deliver great results every year, but that’s simply not possible. Instead, in short, it’s our goal to eliminate disasters, so that every year is either good or great. If a money management firm can do nothing other than produce returns that are at least decent every year, it’s sure to have an excellent long-term record. I truly can say my colleagues have done so, and that we’ve made money for our collective clientele every year since Oaktree opened its doors.

Including our time spent at TCW, we have well over 100 full calendar years of performance records: 19 years in high yield bonds, 18 years in convertibles, 16 years in distressed debt, and so forth. And of those 100-plus years, you’d have to stretch to find one or two when performance fell short of “at least decent,” by which we mean a return that’s good or great in either absolute or relative terms.

Likewise, I’m very proud to say that of the 24 closed-end funds we organized between 1988 and 2003, they’ve all been profitable, with net IRRs to date ranging from 4% to 49%. Again, good or great in every case, with no disasters.

Do we set the bar too low by pursuing performance that’s just “at least decent every year”? I don’t think so. First, I’m sure results of that sort in every year and every fund will give us one of the best long-term records. Second, I know of very few others operating in our fields who’ve done it as long without stumbling. And third, as far as I know no client has ever left Oaktree because they found our performance unsatisfactory. It may sound like a modest goal, but continuing to achieve it is one of my greatest aspirations.

Growth – Oaktree began ten years ago with seven “legacy” strategies: high yield bonds; U.S., international and high income convertibles; distressed debt; principal investments for corporate control; and real estate. We managed \$7 billion in these seven just before leaving TCW to start Oaktree, and we brought over at least \$6 billion. As of year-end 2004 they had grown to \$22.5 billion.

[This first mention of asset growth makes this is a good time for a key aside: we feel many of our best decisions have related to limiting the assets under our management. Marketing efforts in all four of the original “marketable securities” strategies have been curtailed from time to time. (In high yield bonds, for example, we’ve turned away or declined to compete for \$14 billion of new assets since November 1998.) All three of the original “private partnership” strategies have restricted the size of their funds to match the available market opportunities, with good results.]

After spending the years 1995-97 developing our infrastructure and attracting clients to the seven original strategies, we turned in 1998 to expanding our “product line.” In the seven years since, we’ve identified five new strategies that met our criteria (inefficient markets that offer the potential for superior risk-adjusted returns; a way to exploit them with risk under control; and people at hand who’re capable of doing so). Thus we began to manage assets in emerging market equities (1998), European high yield bonds (1999), buyouts in power infrastructure (1999), mezzanine investments (2001) and a credit-oriented hedge fund (2004), with results we’re proud of in every case. It has been our goal to offer helpful new strategies to our clients but not become a “fund-of-the-month club.” And we have required that every new strategy adhere to Oaktree’s investment philosophy.

The expansion of our offerings overlapped with our decision to look beyond the U.S. Before 1998, we had significantly invested abroad only in convertibles. But early that year we concluded that our strengths could be applied internationally. The steps in our internationalization have included the 1998 creation of a London office for the management of European high yield bond portfolios, which began in 1999; formation of our first emerging markets fund at the end of 1998 (which brought the establishment of our research office in Singapore); the creation of a Tokyo real estate office in 1999, which since has broadened its scope to include investments in Japanese corporations; and the initiation of rest-of-world marketing out of London in 2001. In 2004 we opened a Frankfurt office to pursue opportunities in real estate, private equity and distressed debt, and several of our strategies will see further internationalization in 2005 and beyond. The key is for us to remember that there are differences between these markets and the U.S., and thus to proceed cautiously, with the bar held high in terms of required returns.

Finally, we have responded positively to the growing opportunity available to us in serving high net worth investors. While our approach has never included advertising or promotion, we have benefited from word-of-mouth recommendation and from the prominent individuals who first learned of us through institutional relationships. Thus, from \$300 million at the end of 1995, our business with HNW investors has grown to \$1.1 billion today.

For us, Oaktree isn’t a “growth story.” We’ve never had goals in terms of growth rate or assets under management. Rather, we want to serve our clients where we have an advantage. We’ve always been certain that prudent expansion would lead to asset growth, and the results have been most positive: Of our year-end 2004 assets, \$5.2 billion (or 19%) was in the five new strategies mentioned above. Our investments outside the U.S. total \$7.1 billion, and assets managed for clients based abroad stand at \$2.5 billion. Thus, adding in the \$1.1 billion in high net worth

accounts (and even after eliminating the significant double counting among these numbers), it's clear that new directions have contributed a lot to Oaktree's growth in these ten years.

People – The irreplaceable element in producing these results has been people, and I couldn't be more proud of my colleagues. Oaktree started with 42 of us who had worked together at TCW, and we were greeted on that first day by the “advance party” consisting of Chief Financial and Administrative Officer David Kirchheimer (employee #1) and his support crew. The biggest surprise upon starting up was the amount of non-investment work there was to do, but David got us rolling and kept us there.

From that beginning we have grown to roughly 300 people. They're tops in terms of intellect, street smarts and character, and a pleasure to be around. The “second generation” both pushes and supports the first, and the “third generation” is right behind them every moment. I'm glad to say that, together, they have created the harmonious environment we wanted, in which team effort leads to excellent results. The investment management industry is full of brilliant people who can make you a lot of money but are tough to work with. I'm happy to say there aren't any at Oaktree.

And speaking of “happy,” I think our people are. That's very important – not just because we want happiness for them, but also because it'll make them the best for Oaktree and its clients. Our favorite indicator: we think the 139 babies born to Oaktree employees and their spouses in these ten years attest to a very positive mood.

What's the bottom line? All six of the Principals who started Oaktree with me in 1995 are still here. I've worked with my nine fellow Principals for a total of 127 years (exemplified by Sheldon Stone, with whom I'm about to celebrate my 22nd anniversary). In that time – believe it or not – there hasn't been a heated argument or difficult negotiation among any of the ten of us. In twenty years reaching back to our beginning at TCW, there have been only two departures of senior investment professionals that weren't by mutual agreement (excluding the emerging markets group, which has seen significant turnover). And everyone who managed a legacy strategy when we opened ten years ago still manages it today. Certainly none of this is “par for the course” in the turbulent investment industry.

Ownership – Initially, Oaktree was 100% owned by the founding Principals. Over the next ten years we sold roughly 25% to key employees at a price equal to one times the coming year's estimated earnings. This sharing of ownership has produced the desired results in terms of teamwork, satisfaction, shared motivation and personnel retention. We feel it's essential that Oaktree's employees work for the good of all clients, not just those in their own strategy. Broad ownership helps us ensure that.

As you know, a year ago we sold roughly 6% of the firm to seven long-term clients at its fair market value. Our objectives were achieved: personal diversification, of course, but – more importantly – demonstration, by posting a real-world price, that the 60 non-Principal owners had done well and been treated fairly. It's working entirely as we had hoped: the new investors are constructive but not intrusive. What could be better? Doubtless you will see further sales of ownership to third parties over time, but never transferring control. And of course ownership among employees will be broadened further. In short, we like the idea of working together, but not of working for someone else.

Plans for the Future – After reaching ten years and \$28 billion, we run into a lot of people who speak of Oaktree as an established investment institution. Happily, I can tell you my colleagues and I still think of it as a startup, and nothing could bode better for the future. It means we're still engaged and excited, still worried that being too relaxed or too confident could cause us to fail, and still thinking about rising to meet the challenges ahead.

Our goals for the future are simple: more of the same. Performance that's consistently either good or great. Relationships with terrific clients who always feel they're treated fairly. A harmonious workplace shared by bright, happy colleagues who pull together. And, as a result, prudent growth and continuing profitability. Who could ask for more?

The achievement of these goals will always be dependent on you, our clients. "We couldn't do it without you," may sound hackneyed, but nothing could be more true. For the ability to work for and with you, to visit and call you our clients, the people of Oaktree give their heartiest thanks.

April 11, 2005

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