

Memo to: Oaktree Clients
From: Howard Marks
Re: Now It's All Bad?

I'm a great believer in the cyclical nature of the markets, but I never cease to be amazed at how far they can go in one direction and for how long; the extremes they can reach, despite logical arguments to the contrary; and the swiftness of the swing back. It all reminds me of a point I made in my second memo, "First Quarter Performance" (April 1991): Although the midpoint of its arc best describes the location of the pendulum "on average," it actually spends very little of its time there. Instead it is almost always swinging toward or away from the extremes of its arc.

Just seven weeks ago, I complained in "It's All Good" that investors were acting as if nothing could go wrong. "Priced for perfection" was the concept underlying values, and people were more than willing to pay prices set that way.

Now, of course, the prevailing attitude appears to have swung from "it's all good" to "it's all bad." Pessimism has replaced optimism, perhaps also to excess. There are days on which no one seems able to tell me how the developing credit crisis might be resolved in short order and a full-scale meltdown avoided, and when no one seems able to find a ray of sunshine in the current situation (other than bargain hunters).

It's like the aspiring actor who takes acting classes, waits on tables and hustles auditions for a decade . . . and then gets his big break and becomes an "overnight success." Except that in this case, having built up great excesses over a period I date from November 2002, people are now acting as if this market has become an overnight flop.

Some of us have been saying for years that a swing back of the market cycle was due, but it took a long time to happen (calling to mind, as so often in my case, the dictum that "being too far ahead of your time is indistinguishable from being wrong"). This delay does a good job of illustrating Lord Keynes's famous observation that "markets can remain irrational longer than you can remain solvent."

Markets can swing in a single direction for a longer period and to a greater extent than anyone might expect. That's crowd psychology. But the swing back can be equally surprising – in terms of what kicks it off and how fast it moves. I recently came across a great quote from Larry Summers: "in economics things happen slower than you expected they would but when they finally do, they happen faster than you imagined they could." Certainly the recent transition from all good to all bad demonstrates this phenomenon.

The Virtuous Circle

The financial world seems to have melted down in just a few weeks. But the truth is, the seeds of the crisis have been growing for years – unnoticed by most – as a seemingly virtuous circle spun unabated.

Henry Kissinger was a member of TCW's board when I worked there, and a few times each year I was privileged to hear him hold forth on world affairs. Someone would ask, "Henry, can you explain yesterday's events in Bosnia?" and he'd say, "Well, in 1722 . . ." The point is that chain reaction-type events can only be understood in the context of that which went before. The challenge is figuring out how far back to go. In talking about how the market got to its current condition, I'll just look back five years.

Everyone remembers the last corporate debt crisis, during the summer of 2002. Recession, credit crunch, 9/11, Afghanistan, the telecom meltdown, and scandals at Enron and the like combined to make bonds available at ridiculously high yields. Those who were willing to buy had an opportunity to earn ultra-high returns with what turned out to be very little risk.

Around the beginning of November 2002, however, it felt like a switch was thrown. Maybe distressed debt managers who hadn't been aggressive enough during the summer concluded they had to get invested before year-end. For whatever reason, bond prices started to rise. Our active distressed debt funds gained 20% that month, and the markets never looked back. Investors in all asset classes forgot the panic that had gripped them just a few months earlier and became preoccupied with making money.

Because only modest returns were expected from high grade bonds (with their 4-5% yields) and U.S. common stocks (following the 2000-02 bear market), investors sought solutions in non-traditional investments with brief track records at best, and thus little or no clarity regarding the risks involved.

Vast sums flowed to hedge funds, and thousands of new ones were formed. High yield bonds and leveraged loans began to be issued again . . . because now there were buyers. This enabled buyouts to be financed and then recapitalized, and quick payouts to equity holders resulted in eye-popping IRRs, attracting more capital to buyout funds. Real estate attracted vast amounts of capital, too, even when "cap rates" – current cash yields – sunk below 5%; what could be better than a tangible asset providing inflation protection?

Borrowing power became virtually unlimited, as is often the case when providers of capital are eager to put money to work. Thus the financial environment reflected (1) a vast ability to leverage, (2) an uninhibited search for return, and (3) investors competing to make investments by accepting lower returns and decreased safety. This combination supported new investment techniques, which grew rapidly despite being untested. Securitization, tranching and selling onward were employed extensively, often in combination. **For investors seeking high returns in a low-return world, leverage seemed to hold the answer, and it was used in ways never seen**

before. Collateralized loan obligations and collateralized debt obligations, for example, grew practically unchecked. These debt factories bought up vast amounts of raw material – in the form of underlying portfolio assets – in order to generate a salable product.

The bottom line of it all: high leverage, untested vehicles and inadequate preparedness for adverse developments. Little awareness of risk, low credit standards, slender risk premiums and little margin for error. In short, a recipe for possible disaster.

The Vicious Circle

It's easy to explain what happens at this point in the typical market cycle: eventually, everything goes the other way. That's exactly what happened this summer.

There's a bump in the road. It doesn't matter what it is, and it's usually different each time. This year the problem occurred in the field of subprime mortgages. There was a surprising rise in delinquencies, the immediate effect of which was limited to a small segment of the economy and the few investors who'd bought securities backed by these loans. In the months leading up to July, the impact went largely undetected outside the subprime arena.

But from time to time in the investment world, a chain reaction is set off – maybe you'd say a “tipping point” is reached – which causes one sort of problem to create others and to cascade from one asset class, market or region to others.

I think the first step toward a broadening-out of the subprime problem came in a few days during which rating agencies downgraded hundreds of mortgage-backed securities and the debt of CDOs built on them. The repercussions were many and swift. Not only did the downgradings have a direct negative effect on mortgage portfolios and their holders, but they provided a wake-up call, a shocking reminder of some forgotten realities:

- That risk had been underestimated.
- That things investors thought they knew – truths they held so strongly – they really hadn't known at all.
- That elements they had relied on – in this case, debt ratings – had let them down. Nothing works, they were reminded, except analysis that is first-hand, in-depth and superior.

Then there were the holders' problems. Bear Stearns, for example, announced significant losses in two of its hedge funds, as falling prices for subprime holdings rendered collateral inadequate and margin calls eliminated maneuvering room. A few days later, it was reported that the investors' equity was all gone.

And then there are technical factors. These are developments that encourage selling or deter buying but are unrelated to investment fundamentals. A number soon arose:

- Suddenly, market participants realized how hard it can be to value obscure, infrequently-traded assets and how much the prices of such assets can diverge from their value. In fact, “value” can be an empty concept in times of crisis, when it becomes painfully clear that an asset is only worth what it can be sold for. Thus people came to question the prices funds were using to value subprime-related holdings, as well as the model-derived prices their investment bank creators had charged for them.
- Worried about both subprime fundamentals and pricing, and suddenly under increased scrutiny, many lenders stopped providing financing. Short-term commercial paper, which many investors had used to leverage their subprime-related asset investments, became largely impossible to roll over.
- Funds that had promised liquidity to their investors – even some money market funds – became worried about their ability to accurately value subprime holdings and sell them at fair prices. Thus they suspended withdrawals. What could have a more traumatic effect on investor confidence?
- Where leverage was withdrawn, margin calls arrived, or funds had to meet actual or feared withdrawals, holders of subprime assets became forced sellers. Few things have a more devastating effect on investment performance.

Metastasis

The fundamental, psychological and technical influences described above devastated the market for subprime investments, of course, but they also spread quickly to other assets and markets and metastasized into new forms of trouble.

Investor psychology turned in all markets, even those totally unconnected to subprime loans. Caution replaced optimism. Risk aversion took over from risk tolerance (or risk-blindness). Skepticism and the concept of capital preservation were resurrected. Concern over being under-invested gave way to fear of buying too soon. Cash came to be viewed as a source of security and buying power, not a drag on results. All over the investment world, people started to think more about what can go wrong rather than what can go right. **In short, the things that contributed to the virtuous circle began to be reversed, in ways that were unimaginable just two months ago.**

Bridge financing for buyouts represents an outstanding example. Buyouts were an area of great enthusiasm – and some of the greatest excesses, I think – in the 2002-07 up leg:

- Vast sums were raised in buyout funds, likely increasing the managers’ motivation to buy companies.
- Purchase prices for target companies were lifted by stock market strength, bidding wars and the demands of stockholders and boards.

- Acceptable debt/equity ratios – and thus the prices funds were willing to pay for companies – increased as the cost of debt financing fell.
- Companies became even more leveraged as recapitalizations allowed debt to replace equity on post-acquisition balance sheets.

Although purchase prices and leverage ratios were rising rapidly, the banks were ready and willing to “bridge” – or accept the risk involved in completing – future financings for buyouts. Often this came in the form of “staple financing,” through which banks enabled buyers to include committed financing as a component of their bids. As of a month ago, banks had committed to supply \$277 billion of financing for buyouts, a figure that omits equity bridges (promises to raise some of the equity required in a buyout) as well as non-U.S. transactions. These bridges have become one of the big stories of 2007.

Prior to July, investors competed to put money to work despite rising buyout prices, increasing leverage ratios, declining yield spreads and weaker terms and covenants. The banks counted on this eagerness in extending their financing commitments, and for years they were not disappointed.

But then the negative developments in subprime mortgages reminded investors about risk.

- The sight of funds melting down and suspending withdrawals was sobering.
- Worry about the economic impact of falling home prices and less buoyant consumer spending became pervasive.
- In this new, chastened environment, investors who’d bought CLO and CDO debt realized they had put too much faith in favorable ratings and thus were in trouble. This caused their appetite for debt to dry up.
- Bond pricing and terms no longer seemed adequate – and the risk associated with declining to purchase a new issue no longer loomed so large.

In short, in the unique way in which markets can turn from red-hot to frigid, potential buyers lost interest in the financings the banks had committed to place. And so the bridges became “hung.” The banks recognize that this isn’t par paper anymore, and thus they’re likely to accept discount bids to clear it off their balance sheets. **Observers describe this process by saying “risk has been repriced.” They mean investors now realize they’ve been accepting inadequate compensation for bearing risk and are insisting on more.** “Risk repricing” is a good term for what’s happening.

Clearly this phenomenon isn’t limited to subprime debt and bridge financings. In fact, the complete list of impacted securities, markets and participants is staggeringly long and diverse:

- subprime loans, and thus large amounts of residential mortgage-backed securities and CDO debt,
- money market funds that experienced losses in subprime-backed paper and were forced to freeze redemptions,

- Alt-A mortgages – not subprime, but similarly weak on documentation,
- mortgage lenders,
- commercial mortgage-backed securities, not because rents or property values are down, but because these securities may be held by residential mortgage investors forced to raise cash,
- bridge financings – and with them the likelihood of future buyouts looking anything like those of the recent past,
- the investment and commercial banks that committed to the bridges,
- the stocks of target companies in announced buyouts that are shaky as to completion and/or likely to be renegotiated,
- merger arbitrageurs, or “risk arbs,” who assumed the risk of these deals failing to be consummated as announced,
- others who bet that good times and low volatility would continue, and that probable things would happen and improbable things wouldn’t. These include sellers of put options and credit default insurance,
- “quant firms” that built highly leveraged portfolios with help from models that extrapolated past market behavior,
- hedge funds and other leveraged investors in a wide variety of fields that pursued “spread” or “carry” trades using large amounts of borrowed money (more on this later),
- banks (e.g., Germany’s IKB) and fund managers (e.g., Carlyle and KKR) that formed highly leveraged subsidiaries that would employ extensive leverage in the pursuit of profit,
- anyone dependent on issuing commercial paper or other forms of short-term debt to finance leveraged investments, and
- CLOs and CDOs, their investors, and those who depended on them to continue buying debt providing inadequate risk compensation.

The list of affected areas is long and could grow longer. On bad days, losses on U.S. stocks, European stocks and emerging market stocks all are attributed to the credit crunch. Exchange rate swings – and strength in the yen in particular – are blamed on declining use of the carry trade, a regular feature of which was borrowing at low rates in Japan and investing for more elsewhere. And the other day, I read that lower profits at London investment banks will likely result in smaller bonuses for investment bankers . . . and thus in lower prices for London real estate.

How could investors in the areas listed above have expected that a crisis in subprime mortgages would affect them this way? Who would have guessed, for example, that low-grade mortgage delinquencies would depress returns on risk arb funds? The New York Times of August 18 described *A Demon of Our Own Design*, by Richard Bookstaber (see “Investment Miscellany,” November 2000) as pointing out that “the proliferation of complex financial products like derivatives, combined with use of leverage to bolster returns, will inevitably mean that there will be a regular stream of market contagions like the one we’re having now – one of which, someday, could be calamitous.”

This pattern of contagion exemplifies the hidden fault lines that I say can run through portfolios and – like construction flaws in California homes – become apparent only during infrequent catastrophes. But their invisibility most of the time doesn't mean they're not there. The existence of these common threads is one of the things that make it difficult to predict the correlation between assets, one of the key ingredients in intelligent portfolio construction. And it's a good reason to attach a significant premium to managers with alpha, or superior investment insight and skill.

Leverage and Liquidity

It's clear that when the story of 2002-07 is written, leverage and liquidity will be among the main players. For much of the last few years, we saw a vast appetite for securities. It created enormous demand for – and pushed up prices of – real estate- and asset-backed paper, CLO and CDO debt, buyout funds, hedge funds, high yield bonds and leveraged loans. In fact, there seemed to be unlimited demand for non-mainstream investments. With all that money to put to work, few potential buyers refrained from participating in an upswing that some observers thought lacked a sufficient *raison d'être*, reasonable limits and adequate risk compensation.

One of the factors contributing most strongly to that demand was an ability to borrow excessive amounts, for questionable purposes, on loose terms and at a low cost. It was a result of the unattractiveness of yields on high grade debt . . . which stemmed largely from the Fed's campaign to lower interest rates in order to mitigate the depressant effect of the stock market slump and recession. It was abetted by the fact that after a few years of good results, many people forget how money is lost.

Extensive use of leverage was behind many of the gains of the last few years, and it is at the root of many of the problems being suffered today.

If I mistake not, the distress . . . was produced by an enemy more formidable than hostile armies; by a pestilence more deadly than fever or plague; by a visitation more destructive than the frosts of Spring or the blights of Summer. I believe that it was caused by a mountain load of DEBT.

Flowery commentary on the crisis of 2007? No; according to the Financial Times, the quote from T.E. Burton's *Crises and Depressions* refers to events that occurred in 1857.

The point is that leverage is nothing new, and neither are its deleterious effects.

There are numerous reasons to use debt to leverage results, and none of them is likely to evaporate any time soon:

1. Hope springs eternal, as my mother used to say, and greed usually drives markets. Thus any tool that has the power to magnify gains is very tempting.

2. Of course, leverage can magnify losses as well as gains. But investors make investments because they expect them to work, not fail, and thus the attraction of magnified gains far outweighs the fear of magnified losses.
3. **Long-term bonds almost always offer higher yields than short-term debt, and riskier investments invariably seem to promise higher returns than safe ones. For these reasons, using short-term borrowings to finance lower grade and/or longer-term investments invariably appears likely to produce positive returns.**
4. Most seductively, the incremental risk entailed in investments that are slightly longer in term or slightly lower in quality usually appears quite small. **For this reason, these trades seem safe – but that doesn't mean they can't be rendered extremely risky when leveraged up enough.**
5. Of course, when an upward cycle is generating strong returns and making risk aversion recede, the equation becomes even more attractive. In the FT column that provided the above quotation, John Authers describes the regular pattern of good times, easy credit, increasing leverage and eventual crashes. I don't see that ever changing.

It's for these reasons – and especially #4 – that highly leveraged positions are at the root of most fund collapses. Long-Term Capital Management, the Granite Fund, Amaranth Advisors, the two Bear Stearns funds, Sowood Alpha Fund and Basis Yield Alpha Fund were all marked by “safe” positions leveraged to the sky. And they all melted down.

In a number of ways, perpetuation of the market conditions of the last few years was dependent on several assumptions about liquidity:

- that investors with liquidity would be eager to put it to work,
- that providers of capital would make liquidity available, meaning that leveraged investors would be able to maintain their portfolio holdings and buy more,
- that securities markets would remain liquid, such that holdings could always be sold at prices close to their intrinsic value, and
- that funds would therefore be able to keep the promise of liquidity that they'd made to their investors.

In short, it was assumed that liquidity would continue to flow in the direction of leveraged investment funds (in the form of financing and incremental capital commitments) rather than away (in the form of margin calls and investor withdrawals). Two or three months ago the world was described daily as “awash in liquidity.” Where is it now?

Investments requiring nothing more than the perpetuation of favorable market conditions can be very seductive. And they work most of the time . . . until the pit has been dug deep enough, the branches have been spread, and everyone has forgotten about the existence of risk.

The investment environment of the last few years could have been negatively impacted by the removal of any one of the elements of liquidity listed above. But if you look at the list, it becomes clear that they're highly interrelated. Weakening one assumption could render the others less reliable. And, in truth, a single exogenous development – such as a major decline in psychology – could simultaneously harm them all. That's the main story of the last few weeks.

Investments costing many times the investor's equity. Dependence on unreliable short-term financing. Susceptibility to margin calls or capital withdrawals. Assets that can become unsalable at a moment's notice. Prices that can collapse because the markets are thin and everyone wants out at the same time. The formula is simple and the results are predictable. Not every fund that's so disposed collapses, but the potential's always there – with borrowing to buy at its core.

Fundamental problems are present in most investment conflagrations, but exposure to excessive leverage and disappearing liquidity is often the accelerant. As breakingviews.com (my new favorite) put it in The Wall Street Journal of August 2, **“The markets may hurt you, but your lenders will finish you off.”**

Risk Reduction

Of the many fairy tales told over the last few years, one of the most seductive – and thus dangerous – was the one about global risk reduction. It went this way:

- The risk of economic cycles has been eased by adroit central bank management.
- Because of globalization, risk has been spread worldwide rather than concentrated geographically.
- Securitization and syndication have distributed risk to many market participants rather than leaving it concentrated with just a few.
- Risk has been “tranching out” to the investors best able to bear it.
- Leverage has become less risky because interest rates and debt terms are so much more borrower-friendly.
- Leveraged buyouts are safer because the companies being bought are fundamentally stronger.
- Risk can be hedged by long/short and absolute return investing and through the use of derivatives designed for that purpose.
- Improvements in computers, mathematics and modeling have made the markets better understood and thus less risky.

As described in “It's All Good . . . Really?” I thought many things that hinted at risk reduction actually had the effect of decreasing understanding and increasing risk. Up to July, all we read about was the beneficial nature of these developments. Now, with the benefit of hindsight, these are the judgments of our leading business periodicals:

A system designed to distribute and absorb risk might, instead, have bred it, by making it so easy for investors to buy complex securities they didn't fully understand. (The Wall Street Journal, August 7)

[Loans] are now often bundled into securities that are sold in pieces to investors around the world, changing hands many times. It spreads risk, which policy makers believe keeps the overall financial system sound and stable. But the downside to this system could be serious. (WSJ, August 10)

“The market appears to be finding it harder to truly understand the inherent and underlying risks involved,” [according to Chris Rexworthy, a former regulator with Britain's FSA]. The backlash is particularly sharp abroad, in countries that were surprised to find that problems with United States homeowners could be felt so keenly in their home markets. (New York Times, August 31)

“Low volatility has created complacency, and that has translated into poorly structured derivative markets,” says Randall Dodd, director of the Financial Policy Forum . . . The low volatility world of the past few years may have worsened the situation, leading to lax lending standards for derivative investors. (WSJ, August 2)

It is estimated that there are seven times as many credit derivatives outstanding as there are outstanding bonds. You need to ask the question: is risk being transferred or created? Are the new gladiators hedging with derivatives or just leveraging up? (Jeff Pantages in Pensions & Investments, August 20)

An apt metaphor came from Pension & Investments: “Jill Fredston is a nationally recognized avalanche expert . . . She knows about a kind of moral hazard risk, where better safety gear can entice climbers to take more risk – making them in fact less safe.” **Like opportunities to make money, the degree of risk present in a market derives from the behavior of the participants, not from securities, strategies and institutions. Regardless of what's designed into market structures, risk will be low only if investors behave prudently.**

The bottom line is that tales like this one about risk control rarely turn out to be true. Risk cannot be eliminated; it just gets transferred and spread. And developments that make the world look less risky usually are illusory, and thus in presenting a rosy picture they tend to make the world more risky. These are among the important lessons of 2007.

Other Lessons Not Learned

In addition to the above, a number of other recurring themes can be seen as underlying the recent difficulties. Here are a few:

- Belief in market efficiency – Although academics say the actions of intelligent investors cause assets to be priced right, I often find prices screwy. Rather than increasing market efficiency, improvements in computer and communications technology may have made the markets even more unstable. As my partner Sheldon Stone says, it's like a cruise ship where everyone is told to stand on the port side. Then everyone simultaneously gets a message telling them to run to starboard. It makes for a rocky crossing. The New York Times wrote on August 17 that "Information may arrive instantly, but insight takes longer." Certainly the cycles don't seem any less volatile than they used to be, or the extremes any less irrational. In fact, in recent years, over-reliance on market efficiency may have kept people from questioning asset prices.
- Inefficacy of models – Quant funds invest according to models that extrapolate past patterns, operated by people who know computers and probabilities, not investment fundamentals. But models can't tell you when past market behavior has been irrational (and thus unreliable), and they can't predict when those patterns will change. They lead to investments that "would have worked almost all the time in the past," but it's amazing how often we see them derailed by once-in-a-lifetime events. Matthew Rothman of Lehman Brothers has become famous for saying in early August that "events that models only predicted would happen once in 10,000 years happened every day for three days." Are those models you want to bet on?
- Di-worst-ification – Warren Buffett harps on the folly of branching out into things you know less about solely for the purpose of increasing the number of baskets in which you have your eggs. Investing in things about which you aren't expert doesn't reduce risk, it increases it. And I think it's particularly unwise to finance diversification with borrowed money.
- Conflicts between managers and clients – Investors should look very closely at the alignment of their managers' interests with their own. The mere fact that a manager is working for incentive compensation, or has money in his fund, isn't enough. Recent events have shed some unusual – and provocative – light on the question of alignment. Consider Sowood Capital, which lost half of its investors' capital, sold off its portfolio in a block and closed down. Why did the loss of half the LPs' equity occasion a liquidation? Might further losses have activated a clawback of previous years' incentive fees? And might the interests of a manager with 100% of his net worth in his fund have diverged from the interests of LPs who invested 1% of theirs? I'm just speculating from the sidelines without knowledge of the facts in this situation, but I wonder whether this doesn't show that to protect their own investment in their funds, managers can be driven to take actions that damage their LPs.
- The unreliability of ratings – Many investors act in reliance on ratings, and some require ratings before taking actions they're considering. But ratings must be taken with a big grain of salt. **In fact, a lot of my career (and Oaktree's success) has been based on conviction that the rating agencies are often wrong.** They routinely rate securities too high when things are going well, and then overcorrect

All of these paragraphs highlight errors made by investors this time around . . . of a type that always will be made (but with variations on the theme). The lesson isn't to distrust managers, or models, or ratings, or diversification, or market efficiency.

What investors must learn – but most will not – is that there's no easy answer, surefire tool or silver bullet. Lots of tools will help when applied thoughtfully, but they'll bring harm otherwise – with the additional risk that excessive reliance on them will increase the damage done when they turn out to be unavailing. **Certainly none of the highly-touted things discussed above held the answer this time around. Only truly superior skill, discipline and integrity are likely to produce consistently high returns in the long run with limited risk.**

My advice: expect CEOs, regulators, rating agencies and other market participants to make mistakes. Expect things to go wrong and cycles to swing to extremes and then recover. Worry about outcomes, and hire worriers. Doing these things is sure to stand between you and top returns in up-cycles, but it will deliver some degree of safety when things turn bad. **Ensuring the protection of capital under adverse circumstances is incompatible with maximizing returns in good times, and thus investors must choose between the two. That's the real lesson.** The things discussed above are just a few of the details.

What Next?

Lots of people are asking whether this is going to get ugly. Is this the beginning of a credit crunch? Will it lead to a recession? How bad will it get? When will the bottom be reached? How long will the recovery take? The answer's simple: no one knows.

Some of the psychological and technical preconditions for a challenging market environment have been met. The bubble of positive investor psychology has been pricked and could become seriously deflated. **When others are aggressive, we should be worried, but when others are worried, we can be confident. That's the essence of contrarianism, and by that standard these are better times.**

The easy-money machine has had some sand thrown in its gears and seems to be grinding to a halt. Previously, anyone could get any amount of money for any purpose. Right now, deserving borrowers are unable to obtain financing, and this could continue or get worse.

The outlook for the economy is murky, as usual. It continues to limp along, not growing strongly but not sagging. The big question surrounds the effect of the subprime crisis on consumers. Home prices are through rising. Home equity borrowing is probably finished for a while as a supporter of consumer spending. Ditto for the “wealth effect.” The reset of adjustable rate mortgages from artificially low teaser rates to full market rates over the next 18-24 months is likely to have a depressing effect on a large number of households, and thus on the economy. I would think furniture and auto manufacturers, building materials suppliers, retailers and financial institutions have seen their best days for a while. I consider the economy unpredictable, of course, and thus a lot of people’s answers will be more definite than mine. But not necessarily more correct.

Everyone’s looking to the Fed to take action. Its last act – cutting the discount rate on August 17 – was largely symbolic but had a positive effect. A reduction of the federal funds rate would mean more, telling investors the Fed’s there to help, cutting the cost of borrowing and stimulating the economy. But it wouldn’t do much for banks’ balance sheets or willingness to lend.

It’s my view that Bernanke would rather not cut rates. Stimulative action that looked like an investor bailout would contribute further to moral hazard and the expectation that the Fed will always protect investors on the downside. This is an unhealthy expectation, as each bailout encourages risk taking and thus increases the likelihood that another will be needed. But the Fed is being importuned for a rate cut, and there are few people to argue on the other side, for a good dose of unpleasant medicine.

I’m usually cautious, so I might as well keep my record intact. The economy should weaken. Deals built on optimistic assumptions and paid for with a lot of borrowed money shouldn’t all thrive. Generous capital markets should not be expected to bail out ailing companies. Bargain hunters and distressed debt investors will have more to do. Eventually. But no one at Oaktree would advise you to act as if these views are sure to be correct. We certainly won’t.

* * *

An observation I made last October regarding the meltdown of Amaranth, in “Pigweed,” is equally applicable to the recent problems:

Orin [Kramer] notes that Amaranth “occurred when the skies were blue; the fund unraveled because a small and volatile commodity behaved in an unpredicted fashion.” This collapse didn’t require an adverse economic environment or a market crash. The combination of arrogance, failure to understand and allow for risk, and a small adverse development can be enough to wreak havoc. **It can happen to anyone who doesn’t spend the time and effort required to understand the processes underlying his portfolio.**

Certainly the magnitude of this summer's crisis has been out of proportion to its underlying fundamental cause: the increase in subprime delinquencies. Instead, a standard combination has proved perfectly incendiary:

- underlying greed,
- good returns in the up-leg of the cycle,
- euphoria and complacency,
- a free-and-easy credit market,
- Wall Street's inventiveness and salesmanship, and
- investors' naiveté.

This formula often results in crushing losses. **Or as Marc Faber put it, a surplus of cash leads to a shortage of sense.**

An obscure economist named Hyman Minsky is having his fifteen minutes of fame in the current environment. Here's how The Wall Street Journal summarized his views on August 18:

When times are good, investors take on risk; the longer those times stay good, the more risk they take on, until they've taken on too much. Eventually they reach a point where the cash generated by their assets no longer is sufficient to pay off the mountains of debt they took on to acquire them. Losses on such speculative assets prompt lenders to call in their loans. "This is likely to lead to a collapse of asset values," Mr. Minsky wrote. When investors are forced to sell even their less-speculative positions to make good on their loans, markets spiral lower and create a severe demand for cash.

The foregoing aptly describes the current cycle. . . and, I think, the way things always are. It certainly seems inevitable that, eventually, investment merit becomes overpriced, and the combination of good results and easy money causes dangerous leverage to be employed in the pursuit of profit.

When will market cycles be banished or made more muted? That'll happen when greed, human failings and herd behavior are eliminated. Or, in other words, never. In "You Can't Predict. You Can Prepare." I wrote of cycles that success carries within itself the seeds of failure, and failure carries the seeds of success. It'll always be so.

September 10, 2007

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