

Memo to: Oaktree Clients
From: Howard Marks
Re: There They Go Again

Contributing to . . . euphoria are two further factors little noted in our time or in past times. The first is the extreme brevity of the financial memory. . . . There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.

John Kenneth Galbraith
A Short History of Financial Euphoria, Viking, 1990

The above observation has appeared in lots of my memos, second only to Warren Buffett's reminder that our need for prudence in a given situation is inversely proportional to the amount of prudence being displayed by other investors. Neither of these favorite quotations says much for the average investor: Buffett urges us to adopt behavior that is the opposite of John Q. Investor's, and Galbraith points out how prone John Q. is to repeating the mistakes of the past.

It may sound cynical, but most outstanding investors – especially members of the “us school” (see “Us and Them,” May 7, 2004) – understand that the path to superior results lies in taking advantage of other people's mistakes. (The alternative is to think everyone can succeed simultaneously.) It's when most investors take a trend to excess, or the price of an asset to an extreme, that the few people smart and resolute enough to abstain from herd behavior can make truly exceptional profits.

I think both Buffett's and Galbraith's dim views of the average investor are well founded. Although there exist a few rules and reminders that can make it easier to avoid the costliest investing mistakes, most investors rarely heed them.

Investors truly do make the same mistakes over and over. It may be different people doing it each time, and usually they do it in new fields and in connection with new assets, but it is the same behavior. As Mark Twain said, “History doesn't repeat itself, but it rhymes.”

Rarely is the same error repeated in back-to-back years. Usually enough time passes for the repetitive pattern to go unnoticed and for the lessons to be forgotten. Often it's a new generation repeating the errors of their forefathers. But the patterns are there, if you observe with the benefit of objectivity and a long-term view of history.

Why do the mistakes repeat? That's a good question, but not much of a mystery. First, few investors have been around long enough to recognize reoccurrence of the errors of twenty or forty years ago. And second, the greed that argues for ignoring "the old rules" easily trumps caution; hope truly does spring eternal. That's especially true when the good times are rolling. The tendency to ignore the rules invariably reaches its apex in periods when following them has cost people money. It is thus, as Galbraith points out, that those who harp on the lessons of the past are dismissed as old fogies. What are some of the recurring mistakes investors make?

- **It's Different This Time** – Trends in investing are carried to their greatest (and most punishing) extremes by the belief that something has changed – that rules that applied in the past have been rendered obsolete by new circumstances. (E.g., the traditional standards for reasonable valuations weren't applicable to shares in tech companies whose products were likely to change the world.)
- **It Can't Miss** – The fact is, anything can miss. There's no asset so good or trend so strong that you can't lose money betting on it. No investment technique is guaranteed to deliver high returns or keep risk low. Smoothly functioning markets don't permit the combination of high return and low risk to persist – **good results bring in buyers who raise prices, lowering future returns and elevating risk.** It'll never be otherwise.
- **The Explanation Couldn't Be Simpler** – By this I mean to poke some fun at investors' tendency to fall for stories that seem true on the surface but ignore the workings of markets. The stage was set for some of the greatest debacles by platitudes that were easy to swallow – but too simplistic and, in the end, just plain wrong. These include "For a company with good enough growth prospects, there's no such thing as too high a price" (1969 and 1999) and "Emerging markets are a sure thing because of the terrific potential for growth in per capita consumption" (1994).
- **This Tree Will Grow to the Sky** – The fact is, no trend will go on unabated forever. Most trends are limited by cycles, which are caused by people's reaction to developments. Buyers, sellers and competitors respond to trends, altering the current landscape and the future.
- **The Positives of Today Will Still Be Positives Tomorrow** – From time to time, some combination of optimism and greed convinces people that the favorable elements in the current environment – responsible for today's high asset prices – will stay that way. **But (a) things usually turn less rosy, and (b) even before they do, investors take prices to levels that are too high even for today's positives.**
- **Past Returns Are a Good Guide to Future Returns** – The greatest bubbles stem from the belief that high returns in the past foretell high returns in the future. The most successful investors – the longest-term survivors – believe in just the opposite: regression to the mean. The things that have appreciated the most will slow down (or

- **It'll Always Beat the Cost of Borrowing** – Speculative behavior usually features the belief that assets will always appreciate faster than the rate of interest paid on money borrowed to buy them with. We saw a lot of this in the inflationary 1970s. But for the most part, **statements including the words “always” and “never” are usually a sign of trouble ahead.**
- **The Supply/Demand Picture Doesn't Matter** – The relationship between supply and demand determines the price of everything. **The higher the demand relative to the supply, the higher the price for a given asset or strategy. And, the higher the price, the lower the prospective return (all else being equal). Why can't investors remember these two absolute rules?**
- **Higher Risk Means Higher Return** – There are times, especially when the prospective returns on low-risk investments appear inadequate, when people reach for more return by going out further on the risk curve. They forget that riskier investments don't necessarily bring higher returns, just higher projected returns. Forgetting the difference can be fatal.
- **Anything's Better Than Cash** – Because it entails the least risk, the prospective return on cash invariably is lower than all other investments. But that doesn't mean it's the least desirable. There are times when the valuations on other investments are so high that they entail too much risk.
- **It May Be Too Good to Be True, But I Don't Want to Miss Out** – There've been lots of times in my career when people knew something was unlikely to keep working but jumped on the bandwagon anyway. Usually they did so because they thought there was a little bit more left in the trend, or because not being aboard – and watching from the sidelines while others got rich – had become too painful.
- **If It Stops Working, I'll Get Out** – When people invest despite obvious danger signs, they usually do so under the belief that they'll be able to get out when the market turns down. **They rarely ask how it is that they'll know to sell before others do, or to whom they'll sell if everyone else figures it out simultaneously.**

As I sit here in 2005, the picture seems “as plain as the nose on your face.” Investors have found new darlings – real estate, private equity, hedge funds and crude oil – to replace the favorites of ancient history (that is 1999) – technology-media-telecom, biotech and venture capital funds. As I read articles about the new favorites, I find myself saying one thing over and over: **“There they go again.”**

Is it really that hard to remember the events of six years ago? Or is it just so easy to overlook them for the sake of hoped-for profit? Whichever it is, I'm going to take some

time below to go through these areas and cite some rule violations I see occurring. (I'm not saying that these investment areas are without merit. It's just that I wince when I see uncritical analysis and unsupported conclusions.)

Let's take the example of **real estate**. Almost twenty years ago, real estate was the site of many classic mistakes, and lots of money lost. In the mid-1980s, institutional investors charged into real estate, under banners like "They're not making it any more" and "It's a good inflation hedge." What they missed was the fact that:

- while it's true that no one's making more land, there's a lot left to develop, and easy access to capital enables market-glutting buildings to be built on it,
- something's only an inflation hedge if bought at a fair price to start with, and
- unlike the 1970s, inflation wouldn't be an issue for the next twenty years, and thus inflation protection wasn't worth paying up for.

Tax reform in 1987 reduced the demand for tax shelter purposes, and the economic slowdown of the early 1990s turned real estate into a basket case. They still weren't making any more land, but that didn't help institutional investors avoid huge losses.

Today, real estate seems to be the site of investing error again – with no one harking back to the last time around. This is especially true in private homes, with individuals rather than professionals doing most of the "investing." They're lining up to buy houses (often before they're built) that they never expect to occupy, for holding periods too short to repay the transaction costs in the absence of substantial appreciation, and they're financing them with maximum floating-rate mortgages, minimum amortization and little or no money down.

On March 25, 2004, The New York Times compared attitudes toward home buying today and the "dot-com frenzy" of the late 1990s:

... perhaps the most troubling similarity, some analysts say, is the claim that the rules have somehow changed. In an echo of the blasé attitude that "new economy" investors took toward unprofitable companies, the growing ranks of real estate investors are buying houses they never expect to be able to rent at a profit. Instead, they think the prices of houses will just keep rising.

This paragraph points up a key error. In 1999, impassioned investors bought dot-com stocks, not to participate in the underlying companies' profit streams, but to sell them at higher prices. But what could be depended on to make their prices go higher, if not favorable trends in profits? In the same way, rational investors won't count on being able to sell a house at a profit because someone else will pay more for it, but rather because of an increase in its economic value (which usually can be seen in the obtainable rent).

In that vein, The Wall Street Journal of March 22 carried a story comparing the cost of buying and renting. A study of 21 markets by Torto Wheaton Research had found that rent on the average two-bedroom apartment was well below the mortgage payment on the median home. Now certainly the two may not be comparable, and the study ignored such factors as down payments, tax deductions, property taxes, maintenance costs and appreciation. But the most important observation is that, based on national averages, the relationship has changed substantially over the last four years: rent now averages 92% of mortgage payments, down from 102% in 2001.

This relative increase in mortgage payments indicates that today, home prices are based on lower “cap rates.” The capitalization rate on a piece of real estate is the yield implicit in the sale price. Thus a cap rate is analogous to the earnings yield on a stock, which in turn is the reciprocal of its p/e ratio. Bottom line: home prices have risen substantially relative to the underlying (or implicit) cash flows. According to another study, by M/PF YieldStar, the price of the average home rose 16.4% in 2003-4, while the average rent was flat. Certainly real estate valuation ratios are up.

Why are homebuyers paying these higher valuations? Here are some answers, in the form of statements quoted in the New York Times article cited above. How many of the investor errors enumerated on pages 2-3 do you see below?

It’s driven by the same forces [as drove the dot-com stocks]: that investments can’t go bad; that it has the potential to make you rich; that you’ll regret it if you don’t do it; that it looks expensive but really is not.

. . . a limited supply of land coupled with demand from baby boomers and foreigners [will] prolong the boom indefinitely.

I don’t think prices are going to fall, and I don’t think they’re even going to be flat.

It really is a very hot real estate market, and I don’t know how long it’s going to continue. But in the short run, why not profit from it?

I look at this as a short-term investment and plan to unload it as soon as things look dangerous.

I’d bet none of the people quoted above lost money in the last real estate cycle or learned the lessons of the past. **It’s for that reason that they’re prone to mistake the up-leg of yet another cycle for a new and permanent miracle. And so it goes.**

The commercial, retail and residential properties that professionals buy have escalated also – although not as crazily or with as much disregard for valuation. Nevertheless, cap rates are down in response to the general decline in interest rates, demanded returns and risk premiums. With returns on Treasury bonds at 4-5%, fully leased class “A” office buildings apparently look good at 6-7%.

As usual, James Grant supplies a trenchant analysis, this time in the April 25 issue of Forbes. His summary of what's going on in real estate highlights time-honored mistakes that are being repeated:

Markets look forward, except when they look backward. At this moment the real estate market is looking backward. . . .

Mistaking the past for the future, people are pouring money into houses, shopping centers, office buildings, hotels, anything with a front door and a roof. They are paying some of the fanciest prices on record.

Property bulls come in all sizes, shapes and net worths. "We are living with the greatest liquidity ever," an eminent REIT promoter was quoted as saying in March in the New York Sun. "We're not going to have a crash in the real estate market, there is too much liquidity."

Liquidity is a term of art. It means lots of money. It can also mean – and, in 2005, does mean – "low interest rates," "E-Z financing terms," "low dollar exchange rate" and "value investors go away." In an evident state of liquidity-induced euphoria, a Miami Realtor recently proclaimed to The New York Times, "South Florida is working off a totally new economic model than any of us has ever experienced in the past."

Not true. The "South Florida economic model" is the oldest in the book. An excess of dollars leads to a drop in interest rates. And a drop in interest rates to a rise in real estate prices. And a rise in prices to massive new building.

Only later does the same surplus of dollars cause a rise in the inflation rate. This leads to a rise in interest rates. And to a drop in real estate prices, with the market now oversupplied by all that new building.

In other words, we see some instances where investors in real estate are:

- failing to recognize the transitory nature of the factors supporting prices,
- taking comfort from rising prices while they should be alarmed,
- overlooking the lessons of history, and
- declaring "it's different this time."

As Grant points out, "over the last ten years, bricks and mortar had a cash on cash return averaging 3.3 percentage points above the yield on the ten-year Treasury note. . . .

Today, the yield is just 1 percentage point more than that not-very-high number (the ten-year is quoted at 4.5%)." In other words, properties used to provide a solid 3.3% spread over perhaps 6% on the ten-year, for a total return approaching 10%. Now there's a narrow 1% spread over a low base rate . . . for a total current return of 5.5%. The bottom

line is that investors in real estate today have to stress value consciousness and selectivity.

It's not my intention here to pick on real estate in particular or to suggest that it's worse than other markets. It's just that the articles being written about it provide such good examples of some investors' error-proneness.

As I wrote in October, I think we're seeing much of the same in **hedge funds**. Investors here are ignoring price also – this time not relating to the underlying assets, but to fund managers' services. Out of frustration with public, long-only equities (based with the usual hindsight on the 2000-02 debacle), they're looking for the silver bullet in “alpha managers” and “absolute return strategies.” And they're suspending disbelief – just like they do at the movies – to accept that it's possible each year to find thousands of new above-average managers who are capable of piloting thousands of new hedge funds to high returns with low risk in increasingly competitive markets.

In recent weeks, **private equity** has shown up as the belle of the ball. Managers who started the world with \$3-6 billion funds a few years ago are pursuing \$8-10 billion this time with good success. They're able to get it because of recent performance swollen by generous capital market conditions, aided by the assertion that few funds will be big enough to compete for the mega-deals. I don't say these arguments are invalid, but I wonder if investors are worrying enough about some potentially troubling factors:

- the fact that the funds' managers are targeting their lowest returns ever – even though few of their past funds may have achieved their targets,
- the impact on the market for companies of five new funds with \$50 billion to spend – and the possibly underrated likelihood that additional managers will crowd into the “mega” space (I still hold that when the best are closed, the rest will be funded), and
- the effect on the managers themselves of \$100-plus million per year in non-performance-based fees.

Lastly, the recent price surge has made **crude oil** fertile ground for simplistic platitudes and the resulting investor error. Not only aren't they making any more, but our consumption increases every day; rapid growth in China and India implies massive further increases in demand; and much of the supply is in unreliable hands. None of these factors can be disputed. The key question is, “What do they make oil worth?”

I think it's important to note that, unlike cash flow-positive companies and profit-producing companies, it's hard to state the intrinsic value of a commodity or currency. Are you persuaded by the arguments above? Sure you are – I am, too. Do they make oil a buy today, at \$51 a barrel? Certainly. But weren't they just as true a month ago, when oil hit \$58? Didn't they make it a buy then, too? Just as with gold and the Euro, it's hard to say what the right price is to reflect a given set of fundamentals, and whether the

market price is too high or too low. This inability allows prices to fluctuate much more than fundamentals, and makes profitable investment in these things challenging.

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Lately I've been speaking a lot from my last general memo, "Risk and Return Today" (October 27, 2004). In it I expressed my view that (1) the Capital Market Line today is "low and flat," meaning prospective returns in almost all markets are among the lowest we've ever seen, and risk premiums the narrowest, and (2) if prospective returns should rise, it'll likely happen through price declines. Nobody yet has said they disagree with these statements, and I don't think they're just being polite.

But the hard question is, "What can we do about it?"

- Invest as if it's not true. The trouble with this is that "wishing won't make it so." Simply put, it doesn't make sense to expect traditional returns when elevated asset prices suggest they're not available. I was pleased to get a letter from Peter Bernstein in response to my memo, in which he said something wonderful: "The market's not a very accommodating machine; it won't provide high returns just because you need them."
- Invest anyway – accepting relative returns (and the possibility of capital losses.)
- Invest anyway – ignoring short-run risk and focusing on the long run. This isn't irrational, especially if you accept the notion that market timing and tactical asset allocation are difficult. But before taking this path, I'd suggest that you get a commitment from your investment committee or other constituents that they'll ignore short-term losses.
- Hold cash – but that's tough for people who need to meet an actuarial assumption or spending rate; who want their money to be "fully employed" at all times; or who'll be uncomfortable (or lose their jobs) if they have to watch for long as others make money they don't.
- Concentrate your investments in "special niches and special people," as I've been droning on about for the last couple of years. But that gets harder as the size of your portfolio grows. And identifying managers with truly superior talent, discipline and staying power certainly isn't easy.

The truth is, there's no easy answer for investors faced with skimpy prospective returns and risk premiums. But there is one course of action – one classic mistake – that I most strongly feel is wrong: **reaching for return.**

Given today's paucity of prospective return at the low-risk end of the spectrum and the solutions being ballyhooed at the high-risk end, many investors are moving capital to riskier (or at least less traditional) investments. But (a) they're making those riskier investments just when the prospective returns on those investments are the lowest they've ever been; (b) they're accepting return increments for stepping up in risk that are as slim as they've ever been; and (c) they're signing up today for things they turned down (or did less of) in the past, when the prospective returns were much higher. This may be exactly the wrong time to add to risk in pursuit of more return. You want to take risk when others are fleeing from it, not when they're competing with you to do so.

"If you can't get the return you need from safe investments, make risky investments." When put that way, it doesn't make much sense. In fact, it reminds me of my father's joke about the inveterate gambler who said, "I hope I break even, because I need the money."

* * *

If you look back at the recurring mistakes listed at the beginning of this memo, you'll see some common threads. They all express wishful thinking, an inevitable part of human nature. They stem from an excessive proclivity to believe the positives – and disregard the negatives – prompted by the desire to make money.

The key ingredients in being able to avoid these mistakes should be pillars in everyone's investment approach:

- awareness of history,
- belief in cycles rather than unabated, unidirectional trends,
- skepticism regarding the free lunch, and
- insistence on low purchase prices that provide lots of room for error.

Adherence to these things – all parts of the canon of defensive investing – invariably will cause you to miss the most exciting part of bull markets, when trends reach irrational extremes and prices go from fair to excessive. **But they'll also make you a long-term survivor. I can't help thinking that's a prerequisite for investment success.**

May 6, 2005

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