

Memo to: Oaktree Clients

From: Howard Marks

Re: The Long View

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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.

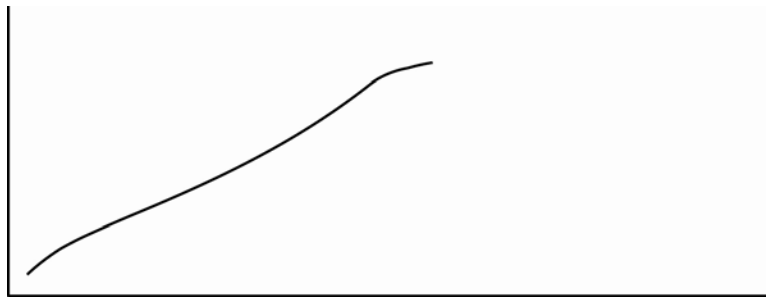
**The Borrowing Mentality** – As further discussed below, advances in financing – and greater acceptance of the use of debt – allowed companies to augment their growth rates and returns on capital and allowed consumers to increase consumption. In fact, over the last several decades, economic units of 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.

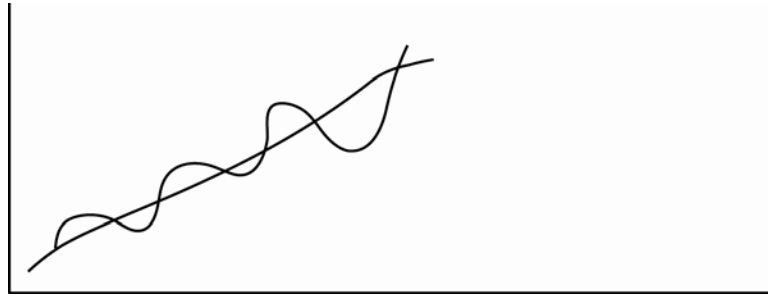
**Investor Psychology** – Attitudes morphed over time. Instead of a generation scarred by the Great Depression, people became increasingly confident, optimistic and venturesome. Experience convinced prospective investors that stocks could be counted on for high returns. In the last few decades, there've 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.



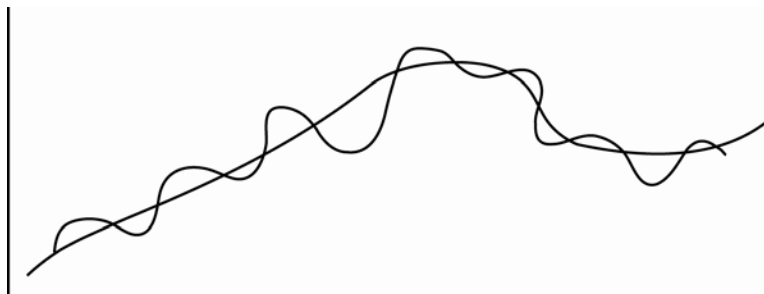
From time to time we saw better economies and worse – slowdown and prosperity, recession and recovery. Markets, too, rose and fell. These fluctuations were attributable to normal economic cycles and to exogenous developments (such as the oil embargo in 1973 and the emerging market crisis in 1998). The 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 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, leveraging 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.

**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.”** 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.**

### Use of Debt in the Corporate World

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 27-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.**

### Go Around, Come Around

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.**

### Trends Just Ahead

**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.**

### The Importance of the Long View

**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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