Memo to: Clients

From: Howard Marks

Re: Microeconomics 101: Supply, Demand and Convertibles

Two principal factors determine whether an investment will be successful. The first is the intrinsic quality of the underlying entity being invested in. In short, how good is the venture you are buying a piece of or lending money to? It's better to invest in a good company than a bad one, ceteris paribus,

[Ceteris paribus is a favorite term of economists. It means “everything else being equal,” and yes, at a given price, it's smarter to invest in a better company than a worse one. Of course, “everything else” never is equal, and you're not likely to be asked to choose between two assets of obviously different quality at the same price.]

The second factor determining whether something will be a good investment is price. Ceteris paribus, given two assets of similar quality, it's better to pay less than more.

Lots of investors take the approach of searching out companies with better products, managements, balance sheets and prospects. Many say they will only buy top quality assets.

Our group does not have that luxury and, at any rate, pursuing museum quality assets would be antithetical to our philosophy. In convertibles, as in high yield bonds and certainly in distressed debt, our companies generally are not widely applauded or atop the ratings heap. Instead, they fall within a broad range in terms of quality.

We are less concerned with the absolute quality of our companies than with the price we pay for whatever it is we're getting. In short, we feel “everything is triple-A at the right price”. We have many reasons for following this approach, including the fact that relatively few people compete with us to do so. But we feel buying any asset for less than it's worth virtually assures success. Identifying top quality assets does not; the risk of overpaying for that quality still remains.

What does all of this have to do with microeconomics? Well microeconomics is the study of the price-setting process, and much of price comes down to a matter of supply and demand.

Ceteris paribus -- in this case, holding the level of supply constant -- price will be higher if there is more demand and lower if there is less. And that's why buying when everyone else is can, in and of itself, doom an investment. Many real estate investments made in the 1980s were ill-fated because excess demand from investors and too-easy credit induced builders to erect structures for which there are no tenants. Many of the later LBOs failed because excessive demand pushed prices for companies to levels which were too high given their prospects.

Conversely, buying what no one else will buy at any price almost assures eventual success, and that leads to a discussion of the current level of demand for convertibles and its impact on their prices.

I wrote this summer that convertibles tend to capture most of the upside performance of stocks while being significantly insulated from declines, and that such performance characteristics should be attractive given the high level of uncertainty today. What I didn't mention -- and what I want to point out now -- is that one of the factors contributing to the availability of bargains among convertibles is the relatively low level of demand for them.

Here in 1992, strong demand has supported stock prices. Important among the components of that demand is the heavy flow into mutual funds of cash fleeing from low-yielding short term investments. But flows into convertible funds have been low, as indicated by the following clipping from Barron's. The figures are worth reviewing.

Convertible securities funds don't get much respect. They had a great 1991, when they rose *30%*, matching the S&P 500, and so far this year, they're up 3.5%, while the S&P is down a fraction. This showing is impressive since convertibles, bond-equity hybrids, are usually a more conservative choice than stocks, trailing the S&P in bull markets and falling less than stocks in down markets.

Yet investors, normally quick to snap up anything offering better yields than CDs and money-market funds are staying away. Assets of convertible funds stood at $2.36 billion on June 30, up just $100 million since the start of the year, and way below their peak of $5.3 billion just before the 1987 crash.

Between 1977 and 1984, the number of convertible mutual funds was constant at seven, and at the end of that period their total assets stood at the princely sum of $452 million. By the end of 1987 there were thirty funds with assets of $5.8 billion, for a thirteen-fold increase. It can clearly be seen in retrospect that the strong flow of capital into convertibles in 1985-87 “poisoned the well” and led to a loss of price discipline, to purchases of over-priced securities, and to poor performance.

Reaction was negative, and convertible mutual fund assets dropped to $3.2 billion at year-end 1989 and only $2.2 billion today, down 62% from the 1987 level. If strong inflows are, as I believe, a precursor of poor performance (and vice versa), then the outlook today should be excellent. Convertibles are getting no respect and attracting no inflows. That leaves bargains for those willing to act as contrarians. We hope you will consider convertibles an attractive way to hold an increased portion of your commitment to equities.

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