Memo to: Oaktree Clients and Friends

From: Howard Marks

Re: Who Knew?

For years, I've railed against people who claim they know what the future holds. And yet, in my last memo on September 3, 1997, I may actually have made a correct prediction, as follows:

> What could cause a market decline? A drop in investor confidence -- perhaps the commodity that's most freely available today -- would likely be the key, but the reason is hard to foresee…. The next surprise might be geopolitical (oil embargo, war in Korea), economic (tight money, slowing profit growth) or internal to the market (competition from bonds at higher interest rates, discovery of a fraud), but it's most likely to be something that no one has anticipated -- including us.

Just the next month, the "Asian meltdown" came into full bloom, with profound ramifications for stock and bond markets all around the world.

What this shows is that it's easy to be right about the future . . . if you restrict your predictions to two: (1) something significant is bound to happen eventually, and (2) we never know what it'll be.

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Speaking of what we can know, I was in a client's office in December, cautioning that I thought we would never reside for long in the investment nirvana of the new paradigm where inflation, interest rates, economic growth, expanding profits and rising stock prices stay properly aligned. He said, "I'd think a self-professed non-forecaster like you would never say, 'never'."

My response was, "Maybe it's a result of my sobering experience in the 1970s, but there are plenty of things I'll say "never" to ... on the negative side: Things will **never** go right forever. Investors' fondest hopes will **never** fail to be dashed eventually. Some unpleasant surprises will **never** fail to arise."

This sounds terribly negative, as if I think good things are rare and only bad things are bound to happen. But if you think it over, I hope you'll conclude I'm not what our Kevin Clayton calls a "Negative Ned."

I read decades ago that every bull market has three stages:

> The first, when a few far-sighted people begin to believe that some improvement is possible,
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> the second, when most investors come to agree that improvement is actually underway, and
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> the third, when everyone believes everything will get better forever.

If you're going to succeed at all in timing cycles, the only possible way is to act as a contrarian: catch some opportunities at the bottom, let your optimism abate as prices rise, and hold relatively few exposed positions when the top is reached. To find bargains at the bottom, you don't have to think that things will get better forever; you just have to remember that every cycle will turn up eventually, and that prices are lowest when it looks like it won't. But it's just as important to avoid holding at (and past) the top, and the key is not to succumb to the popular delusion that "trees will grow to the sky."

What I think is important is that, although markets can be underpriced or overpriced and yet go on for months or years to become even more so, **it's most prudent to be optimistic when no one else is, and it can be highly profitable. But it can be dangerous to be optimistic when everyone else is, and very costly.**

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All of the above might be interesting, but of course the crucial question is "Where do we stand today?"

Certainly, the secret's out: something bad can happen -- and has. We see Asian currencies, economies and perhaps social orders in free-fall. But what strikes me is the fact that the major U.S. equity indices are just about where they were when I wrote in September. Our market justifiably benefits from a flight to quality, and it is true that many of our companies may not be directly affected by the Asian turmoil. **But are the people pricing stocks near all-time highs too optimistic, too pessimistic, or just right?**

What amazes me is that even though people say "the market abhors uncertainty," it has been doing rather well despite the large number of things that no one can pretend to fully understand.

1) How bad will the Asian crisis get, how far will it spread, what solution is possible, and what will be the second- and third-order ramifications on our economy and companies? Will governments topple? Will contracts be abrogated? How many people who are sanguine about U.S. equities today can answer these questions concerning Asia (and how can you be the former if you can't do the latter)?

2) Most accounts of the developments in Asia touch on overcapacity, on stiffened competition from Asian exporters whose prices are now lower in dollar terms because of devaluations, and on the possibility of deflation in the U.S. Even Chairman Greenspan thought enough of deflation to mention it last Saturday. And yet, who really knows what these things might mean for economies and companies around the world? In short, is deflation good or bad? How can you feel comfortable if you can't answer these questions?

3) A reading of the newspapers in the last few months discloses a steady drumbeat of earnings disappointments and revived restructurings and layoffs. How strong is our economy? Are cost increases putting pressure on profits? How much will earnings growth slow down?

These are all questions that indicate that negatives are present in our investment environment. But they're always there -- sometimes obvious and sometimes not.

Prices near highs and optimism in bloom -- that's a dangerous combination, especially with perceived risk on the rise. Peter Bernstein wrote around 1979 that "The great buying opportunities ... are never made by investors whose happiest hopes are daily being realized." And yet many of today's investors have only known success, and few appear seriously chastened by recent developments. This permits me to conclude that **this is not a buying opportunity and, although no collapse need be imminent, the stock market's best days are behind it for a while.**

Or as our client, Mike Herman, wrote in the annual report of the Kaufman Foundation, the Investment Committee of which he chairs: "It truly doesn't get much better than this -- a statement which in and of itself should inspire caution, not complacency. If things can't get much better, logic suggests they can only stay the same or get worse."

My bottom line is that while the best bargains are found when it looks like things can't get better, bargains are hard to find when things can only get worse -- especially if few people seem to know it. That's why Oaktree always tries to keep in mind where we stand, to buy avidly only when fear is at a high level, and to utilize asset classes, strategies and tactics that prepare us for the negatives that are always lurking out there somewhere.

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DJIA = 7,802

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