Memo to: Oaktree Clients

From: Howard Marks

Re: Investment Miscellany

Because I've been encouraged by the response to my "bubble. com" and venture capital memos, I'm going to keep writing. Over time, I collect ideas that I'm tempted to pass on to you - nothing major, but miscellany that may be of interest. Sharing them might become a habit; let me know if you think it should.

Can't Get Any Respect

The behavior of IPOs and hot tech stocks in the last few years perverted everything that traditionally had held true. The episode that crested in March must have been the greatest bubble of all times. Certainly money was made in amounts and at speeds never seen before. Companies went from business plan to IPO in a year or two, with billions of dollars assigned to them in market capitalizations or bestowed on their founders and venture capital backers.

In the last twelve months, technology entrepreneurs and investors on both coasts bought homes costing several tens of millions of dollars. The line of eager buyers pushed up prices for private planes, yachts and beachfront homes. The market for art and antiques grew white hot. In short, as a friend of mine says, "money was disrespected."

Traditional investing values were equally disrespected. Risk was viewed as the investor's friend, and caution as unnecessary and unavailing. Profits - and even profit projections - were considered superfluous. The slow and steady ways of making money came in last, and the riskiest schemes paid off best. Venture capital funds produced triple-digit returns in a year, and profitless technology company IPOs did so in a day.

On the other hand, investors seemed incapable of remembering why they had fixed income allocations, and value stocks and absolute return strategies weren't far behind in terms of disregard. In May of 1999, I heard John Angelo of Angelo Gordon put it brilliantly:

> Twenty years ago, when I told people I could make them 15% a year, year in and year out, they said "That's impossible." Today, when I tell people I can make them 15% a year, year in and year out, they say "Who cares?"

To illustrate, take the case of high yield bonds, whose prices have been sagging, partly because of steady capital flows out of high yield mutual funds (for redeployment in equity funds). I was asked the other day when flows into high yield bonds would resume. My answer: When people realize once again that 11 % is a good return.

But this disrespect for traditional investment thinking shall pass--and in fact it appears to be in the process of doing so. In general, the portfolios that did best last year have done worst so far this year, and vice versa. Traditional investing values will be respected again. I can even imagine a day when words like "prudence" return to investors' everyday speech.

It Restores Your Faith

If common sense and logic don't work, how are we to run our lives? In "bubble.com" I battologized (look that up in your Funk & Wagnall's) regarding the dot-coms' divergence from the old-fashioned notion that only if revenues exceed expenses is a business attractive. Instead, in 1999 business models were based on giving away products as a way to get ads in front of eyeballs, or on selling things for less than they cost.

WebHouse Club is a poster child for failed giveaways. A spin-off of Priceline.com, it let customers name their own price for groceries and gas. There was a problem: manufacturers were unwilling to supply goods at the prices customers wanted to pay, so WebHouse made up the difference. In "bubble. com" I related several old jokes about the businessman who sells below cost, but I never expected to see life imitate art so precisely. Anyway, WebHouse's backers lost their enthusiasm for absorbing the losses (the fall of their Priceline stock from $170 to $3 may have had something to do with it), and the company ceased doing business on October 5.

I find it reassuring that entrepreneurs (and, more significantly, the investors expected to fund them) are realizing that profitless "business models" are untenable. Internet retail firms are shutting down, especially those in overpopulated "spaces." Now, I'm told, the newest "b-to-c" among Silicon Valley employees is "back to consulting." Last year, Goldman Sachs had trouble recruiting the **MBA** it needed; this year the interview rooms are overcrowded again.

What Can Reasonably Be Expected from Equities?

In a little drama that I'm sure has played out at thousands of organizations in the last year, a charitable organization investment committee that I chair began to question its conservative portfolio and ask whether it should have more in equities. As a result, we commissioned some bond/stock allocation work from our consultants. Its conclusions were most curious.

Their model called for higher equity allocations, predicting that they would lead to higher overall returns on the portfolio and lower risk. Why? Because equities were projected to return 14% and risk was defined as the probability of failing to average 8% over a five-year period.

First, I said, I would never have any part in a process that equated higher equity allocations with lower risk. I suggested that risk be defined as overall portfolio volatility, and that took care of that.

But second, I questioned the 14% projected return from equities. Equities returned 28% in 1995-99, I said; did someone think halving that made for a conservative projection? No, I was told, the support mostly came-from the 13% long-run return on equities:--(I always thought it was 10% or so, but it seems the last five years have changed all that.)

I could only think of one way to respond: I offered to put up my money against that of the consultant's researchers and "take the under." I doubt strongly that equities will return 14% or anything like it in the next decade. Corporate earnings have traditionally grown at single-digit rates, and I don't feel that's about to change substantially. With p/e ratios unlikely to rise further and dividends immaterial, single-digit earnings growth should translate into single-digit average equity performance at best for the foreseeable future.

In the end, I feel there has been unreasonable reliance on the average historic return from equities, be it 10% for 1929-92 or 13% for 1940-99. What's been lost track of is the fact that p/e ratios were much lower when these periods began and since then have risen substantially. I just don't believe that further p/e expansion can be counted on. How do I view the issue? I ask the bulls one question: **What's been the average performance of stocks bought at p/e ratios in the twenties?** I don't think the return has been in double digits. I'm not even sure it's been positive.

A Framework for Understanding Market Crisis

I want to call your attention to an excellent paper with the above title written by Richard Bookstaber, head of risk management for Moore Capital Management. It was published in the proceedings of an AIMR seminar on "Risk Management: Principles and Practices" (August, 1999). What smart people do is put into logical words the thoughts we may have had but never formulated or expressed. In his article, Bookstaber has done a great job of explaining the forces behind market crisis.

I'll try to summarize his analysis, borrowing extensively from his words but adding my own interpretation **and** emphasis, there'll be some slow going, but I think you'll find it worthwhile.

- Most people think security price movements result primarily from the market's discounting of information about corporate, economic or geopolitical events - so-called "fundamentals." If you sit with a trader, however, it's easy to observe that prices are always moving in response to things other than fundamental information.

- Bookstaber says “the principal reason for intraday price movement is the demand for liquidity .... In place of the conventional academic perspective of the role of the market, in which the market is efficient and exists solely for informational purposes, this view is that the role of the market is to provide immediacy for liquidity demanders.....**By accepting the notion that markets exist to satisfy liquidity demand and liquidity supply, the framework is in place for understanding what causes market crises, which are the times when liquidity and immediacy matter most.”**

- “Liquidity demanders are demanders of immediacy.” I would describe them as holders of assets in due course, such as investors and hedgers, who from time to time have a strong need to adjust their positions: When there's urgency, “the defining characteristic is that time is more important than price .... they need to get the trade done immediately and are willing to pay to do so.”

- “Liquidity suppliers meet the liquidity demand.” They may be block traders, hedge fund managers or speculators with ready cash and a strong view of an asset's value who “wait for an opportunity when the liquidity demander's need for liquidity creates a divergence in price [from the asset's true value]. Liquidity suppliers then provide the liquidity at that price.” What they offer is liquidity; providing liquidity entails risk to them (which increases as the market's volatility increases and as its liquidity decreases); and the profit they expect to make is their price for accepting this risk. “To liquidity suppliers, price matters much more than time.”

- Usually when the price of something falls, fewer people want to sell it and more want to buy it. But in a crisis, “market prices become countereconomic,” and the reverse becomes true. “A falling price, instead of deterring people from selling, triggers a growing flood of selling, and instead of attracting buyers, a falling price drives potential buyers from the market (or, even worse, turns potential buyers into sellers.)” This phenomenon can occur for reasons ranging from transactional (they receive margin calls) to emotional (they get scared). The number of liquidity demanders increases, and they become more highly motivated. “Liquidity demanders use price to attract liquidity suppliers, which sometimes works and sometimes does not. In a high-risk or crisis market, the drop in prices actually reduces supply [of liquidity] and increases demand.”

- In times of crisis, liquidity suppliers become scarce. Maybe they spent their capital in the first 10% decline and are out of powder. Maybe the market's increased volatility and decreased liquidity have reduced the price they're willing to pay. And maybe they're scared, too. Bookstaber recalls the Crash of 1987. After the first leg down, liquidity suppliers “had already ‘made their move,’ risking their capital at much lower levels of volatility, and now were stopped out of their positions by management or, worse still, had lost their jobs. Even those who still had their jobs kept their capital on the sidelines. Entering the market in the face of widespread destruction was considered imprudent ... Information did not cause the dramatic price volatility. It was caused by the crisis-induced demand for liquidity at a time that liquidity suppliers were shrinking from the market.”

- “One of the most troubling aspects of a market crisis is that diversification strategies fail. Assets that are uncorrelated suddenly become highly correlated, and all positions go down together. The reason for the lack of diversification is that in a [volatile] market, all assets in fact ***are*** the same. The factors that differentiate them in normal times are no longer relevant. What matters is no longer the economic or financial relationship between assets but the degree to which they share habitat. What matters is who holds the assets.” In recent years, the “habitat” in which most investors feel comfortable has expanded. Barriers to entry have fallen, access to information has increased and, perhaps most importantly, most investors' forays abroad have been rewarded. Thus “market participants become more like one another, which means that liquidity demanders all [hold] pretty much the same assets and grab whatever sources of liquidity are available.” If they **are held by the same-traders, “two types of unrelated-assets will become highly correlated because a loss in the one asset will force the traders to liquidate the other.”** That's not a bad explanation for the fact that when Long-Term Capital and the emerging markets crashed in September 1998, high yield bonds and other unrelated asset classes fell with them.

I hope you'll recognize in the above some of the elements behind the Oaktree approach, as exemplified by our work with distressed debt.

- We look for Bookstaber's “liquidity demanders,” with their exogenous motivations. We call them forced sellers, and they provide our best bargains.

- We take advantage when “noneconomic” market conditions increase the pressure to sell even as asset prices move lower.

- And we rarely approach holders to buy, preferring to wait until they call us. In that way we are “liquidity suppliers” rather than eager buyers. Take it from me, the latter pay more.

Many of us may have had thoughts like Bookstaber's, and in my 30+ years in money management I've had plenty of chances to watch liquidity demand **soar,** liquidity supply dry up**,** prices collapse and diversification fail. But I respect someone who can put into a rigorous framework that which “everybody knows.”

Speaking of panics, we all recognize the carnage that occurs when the desire to sell far exceeds the willingness to buy. But I think Bookstaber's analysis applies equally to the opposite - times when the desire to buy outstrips the willingness to sell. It's called a buying panic and represents no less of a crisis, even though - because the immediate result is profit rather than loss - it is discussed in different terms. Certainly 1999 was just as much of an irrational, liquidity-driven crisis as 1987. While some of the ramifications have been seen thus far this year, I think there's more to come.

Knowledge Versus Information

If Bookstaber's article made brilliant sense of a market phenomenon, what's the opposite? For an example, I would look to "Stock Hoax Should Affirm Faith in Markets" by James K. Glassman (Wall Street Journal, August 30). Glassman's name may be familiar to you, because my memo of May 1, 2000 took issue with "Dow 36,000," a book he co-authored. Now it's a pleasure to take issue with him again.

Glassman's book said the Dow should be at 36,000 because stocks' multiples should be much higher than they are. Multiples should be higher because there's so little risk in stocks, and thus investors needn't incorporate a risk premium. I didn't think that argument made any sense, and I don't think the recent article makes any, either. This time, Glassman argues that one of the things greatly reducing the riskiness of stocks is the technology being employed in the markets, most notably the Internet. Because information is disseminated so rapidly and thoroughly, investing entails less risk, so stocks are a better place to be. As he puts it, "The Internet - simply as a tool to get financial information out speedily - has had the effect of raising stock prices, perhaps permanently. In that way, the new technology has added hundreds of billions of dollars to the wealth of U.S. investors."

Paradoxically, Glassman finds proof of this in the Emulex incident. On August 25, 2000, a false press release was picked up on the Internet, taking Emulex stock from $103 to **$45** within twenty minutes. After a few-hour trading halt, corrected information took it back above $100. Glassman's term for the markets: "dazzling in their efficiency."

He finds comfort in the fact that both the falsified data and the correction were disseminated so quickly. I feel the rapid and universal distribution of information - often at speeds and in amounts that make it impossible to verify, distill and understand - does nothing to make the markets safer *per se*. For proof, look at the trend in volatility. It seems inescapable that media hype and other short-term oriented developments have made the markets more treacherous.

Looking at today' s mass market and the associated flood of information, my partner Sheldon Stone sees investors as passengers on a boat, running back and forth *en* masse -to one side in response to new information, and then back to the other. That makes for a rocky crossing.

Where does Glassman go wrong? To me, his error is obvious in the following sentence:

> Markets know so much more about companies, and know it so quickly, that their assessments of worth have an up-to-the-minute efficiency and accuracy.

The bottom line for me: **Efficiency and accuracy are two very different things.** As I wrote in my May memo, investors rapidly incorporate new information into their estimates of security values, and the market rapidly reflects the consensus view of values,...but that doesn't mean the consensus is right. **Information isn't knowledge.** The mere fact that investors have data doesn't mean they understand its significance. If investors' knowledge was really growing, stock volatility wouldn't be increasing as dramatically as it is. As the adage says of the fool, “he knows the price of everything and the value of nothing.”

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