Memo to: Oaktree Clients

From: Howard Marks

Re: Safety First . . . But Where?

Are you from the old school? Do the following terms sound familiar?

- fiduciary duty
- preservation of capital
- risk aversion
- dividend yield

Although in common use prior to the 1980s, they've been heard less and less since then. For this reason, a score of zero means you are completely modern, two means you're so-so, and four means you are far behind the times. I fall solidly into the last category. That means much of what I heard and read in the late 1990s made absolutely no sense to me.

Of course, just as momentum investing eventually gives way to contrarianism (and vice versa), periods when carefree investing is highly rewarded eventually come to an end, as happened in 2000. I am writing to explore the question of where to look for successful investments when sheer aggressiveness stops paying off.

"A-B-C," my Uncle Jack used to say when he taught me how to cross the street, "always be careful. Stop and look both ways." Most of us start off that way, but after a period when few cars come and the people who rush headlong get there fastest, caution sometimes is cast aside.

Just as standing frozen with fear is no way to move ahead, investors occasionally are issued a reminder that not worrying about danger can be just as foolish. Pursuit of return must be balanced against aversion to risk. The latter came to be accorded far too little attention as the 1990s wore on, but that seems to have been corrected. Where can we look now for good risk-adjusted returns?

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What's Been Tried?

Common stocks – Among the mantras that were repeated in the past decade, few received as much credence as "stocks outperform." Wharton's Professor Jeremy Siegel documented in his book, "Stocks for the Long Run," that equities have beaten bonds, cash and inflation over almost all long periods of time. In fact, his graph of the movements of the stock market over the last 200 years looks like a straight line from lower left to upper right. Evidence like this convinced people to increase their equity allocations while continuing to sleep well. Little did they know that the price gains that made them feel so sanguine about their positions were dramatically increasing their risk.

I am a great believer in common stock investing, but I hold tight to a few caveats:

- Return expectations must be reasonable.
- The ride won't be without bumps.
- It's not easy to get above-market returns.

We live in the world's most productive economy, under a very effective capitalist system, at a wonderful point in time. In general, it's great to own productive assets like companies and their shares. But occasionally, people lose track of the fact that in the long run, shares can't do much better than the companies that issue them. Or to paraphrase Warren Buffett, when people forget that corporate profits grow at 8 or 9% per year, they tend to get into trouble.

It's never clear what base period makes for a relevant comparison, but between 1930 and 1990, annual returns from stocks averaged about 10% per year. Periods when they did better were followed by periods when they did worse. The better periods were usually caused by the expansion of p/e ratios, but valuations tended to return from the stratosphere, and returns roughly paralleled profit growth in the long run.

There always will be bull markets and bear markets. The bull markets will be welcomed warmly and unskeptically, because people will be making money. They will be propelled to great heights, usually by the rationalization that "it's different this time; productivity, technology, globalization, lower taxation – something – has permanently elevated the prospective return from stocks."

The bear markets will come as a shock to the unsuspecting, demonstrating that, most of the time, the world doesn't change that much. For example, when you look at Siegel's 200-year straight-line stock market graph, no hiccup is visible in 1973-74. Try telling that to the equity investors who lost half their money.

The bottom line is that risk of fluctuation is always present. Thus stocks are risky unless your time frame truly allows you to live through the downs while awaiting the ups. Lord Keynes said "markets can remain irrational longer than you can remain solvent," and being forced to sell at the bottom – by your emotions, your client or your need for money – can turn temporary volatility (the theoretical definition of risk) into very real permanent loss. Your time frame does a lot to determine what fluctuations you can survive.

Active management – In order to get more out of the ups and try to lessen the pain of the downs, most people turn to active management via market timing, group rotation, industry emphasis and stock selection. But it's just not that easy. The American Way – earnestly applying elbow grease – doesn't often payoff.

As you know, I believe most markets are relatively efficient, and that certainly includes the mainstream stock market. Where lots of investors are aware of an asset's existence, feel they understand it, are comfortable with it, have roughly equal access to information and are diligently working to evaluate it, the market operates to incorporate their collective interpretation of the information into a market price. While that price is often wrong, very few investors can consistently know when it is, and by how much, and in which direction.

The evidence is clear: most investors underperform the market. They (a) can't see the future, (b) make mistakes that keep them at a disadvantage, (c) accept high risk in their effort to distinguish themselves, and (d) spend money trying (in the form of market impact and transaction costs).

Of course, there are individuals who beat the market by substantial margins, and they become famous. The mere fact that they attract so much attention proves how rare they are. (That's the meaning of the adage "it's the exception that proves the rule.") Adding to return without adding commensurately to risk requires rare understanding – of how money is made and what constitutes value – and far more managers promise it than have it. I was recently on a panel that was asked what gave our firms their edge. One panelist responded "we have 160 analysts around the world." To me, that response demonstrated a total lack of insight. Unless those 160 analysts are more astute than the average investor, they'll contribute nothing. Certainly another 160 wouldn't double the manager's ability to add value. (If they could, everyone would be an analyst.)

Most active managers go through times when their biases or their guesses lead them to do things that beat their assigned benchmark, which they attribute to their skill, and times which are the opposite, which they attribute to being blindsided by the unforeseeable (or to some defect in the benchmark). But these are two sides of the same coin, and in the long run the average manager adds little. Usually, active management will not allow you to beat the stock market, or to enjoy the fruits of the market without fully bearing its risk.

Indexed equities – Thirty years or so ago, investors began to concede that while it was desirable to participate in the stock market, it wasn't worth trying to beat it. Under prodding from academics at the University of Chicago and practitioners such as John Bogle of Vanguard, there began a trend toward index funds, with their low costs and assured inability to underperform.

The essence of index investing was a "passive portfolio" that represented a relatively unbiased sample of the universe of stocks. The Standard and Poors' 500 was the immediate choice and quickly became synonymous with "stocks" and "the market."

With every period in which active managers underperformed, the trend toward indexing got another boost. The percentage of equities held via index funds rose. In the mid-to-late 1990s, when large-cap growth stocks hogged the spotlight, passive investing outperformed. (That's an oxymoron, isn't it?) But as the groups most heavily represented in the S&P did best, indexation was in fact looked at as an offensive weapon.

As the tech stock boom reached its apex in 1999, even the keepers of the S&P 500 succumbed to the trend. In order to stay "modern" and "representative," they threw out low-priced Old Economy stocks that had lagged and substituted hot tech names such as Yahoo!, Broadcom, JDS Uniphase and Palm. The effect – the error – was classic.

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Adding a fast-rising tech stock to the S&P made index funds buy it, as well as active managers measured against the S&P. This added further to the stock's momentum, in a self-fulfilling cycle.

By the end of 1999, technology stocks constituted roughly 40% of the S&P, and thus it no longer delivered "unbiased" participation in equities. Prudent index investors looked for alternatives like the Russell 5000, while trend-followers threw more and more money into the S&P. As usual, investors got carried away with the simplistic solution; in some people's minds, index funds' infallibility was transmuted from "incapable of failing to capture the gains of stocks" into "incapable of performing poorly." Of course, money flooded in.

The cycle turned, as it inevitably does. The recently added tech stocks hurt the S&P in 2000, and indexers underperformed active managers. On March 30, 2001, The Wall Street Journal wrote: "For investors with index-fund holdings, the market downturn makes the forget-about-it approach a much less appealing strategy then when stocks are climbing." As the kids say, "Duh!"

Stocks of great companies – Over the years, buying and holding the stocks of leading companies has been a favorite way to strive for high return and low risk. In 1999 I heard lots of people say they were buying Microsoft, Intel and Cisco because they were sure to lead the technology miracle. They still are, and yet their stocks are now down 53%, 68% and 83%, respectively, from their highs.

People too easily forget that in determining the outcome of an investment, what you buy is no more important than the price you pay for it. As Oaktree consistently demonstrates, we'd much rather buy a so-so asset cheap than a great asset dear.

The stocks of great companies often sell at prices that assume their greatness can be perpetuated, and usually it cannot. While in business school in the 1960s, I read a brochure from Merrill Lynch introducing a novel concept called growth stock investing. Many of the stocks it profiled went on to be pillars of the Nifty-Fifty by the time I joined the First National City Bank in 1969. It was the party line that if the company you invest in is good enough and growing fast enough, there's no such thing as too high a price. Along with lots of companies that are still considered great, the Nifty-Fifty included such average companies of today as Avon, Kodak and Polaroid. Starting from their 1973 highs, we estimate these stocks' respective annual returns at .4%, (.4%) and (10.4%)! **"Great company today" doesn't mean "great company tomorrow," and it certainly doesn't mean "great investment."**

On February 7, 2001, the Wall Street Journal carried "Unsafe Harbors: Folks Who Like To Buy A Stock and Forget It Face Rude Awakening." It said,

> Big, industry-leading companies are being rocked by everything from deregulation to cutthroat competition to fast-changing technology that can shift an industry's balance overnight. The speed of change today is changing the concept

> of a few safe stocks, which you can just buy and sock away, into almost an investment relic.

The Journal supplied lots of evidence showing how risky it can be to buy and hold stocks thought to be great:

- Among the 50 largest stocks in the S&P 500, almost half lost 20% of their value last year; . . . even in 1999' s bull market 10 of these top 50 stocks fell by that much.
- Ten of the 50 biggest stocks lost 20% in a single day last year.
- In each of the past three years, an average of eight of the 50 stocks in the S&P 500 sporting the highest dividend [yields] dropped 20% or more in a month.

A February article in Fortune magazine, covering 1960-80, 1970-90 and 1980-99, showed that out of 150 candidates among large companies, only four or five in each period were able to grow earnings per share at 15% per year on average. Can you guess the only company that did it in all three periods? It was Philip Morris. And yet despite that unequalled record, its stock rose only 7.6% per year in 1991-99, (13.0% per year behind the S&P 500), because of concern over tobacco litigation.

Pursuing quality regardless of price is, in my opinion, one of the riskiest – rather than the safest – of investment approaches. Highly respected companies invariably fall to earth. When investors' hopes are dashed, the impact on price is severe. For example, if a high p/e ratio is attached to earnings that are expected to grow rapidly, an earnings shortfall will cause the p/e ratio to be reduced, bringing about a double-barreled price decline.

Lord Keynes wrote "speculators accept risks of which they are aware; investors accept risks of which they are unaware." As Keynes's definition makes clear, investing in the stocks of great companies that "everyone" likes at prices fully reflective of greatness is enormously risky. We'd rather buy assets that people think little of; the surprises are much more likely to be favorable, and thus to produce gains. No, great companies are not synonymous with great investments . . . or even safe ones.

High-grade bonds – After several years in investment exile, traditional fixed income instruments racked up good absolute returns and super relative returns in 2000. (For example, the Lehman Brothers Government/Credit Index was up 11.9%.) But don't bet on a repeat.

First, I don't believe bonds should be bought with an expectation that their returns will exceed their promised yields. That means 4-6% on governments and 6-8% on high-grade corporates.

Second, government bonds are quite highly priced today, thanks to:

- the flight to quality that resulted from the pain in the stock and high yield bond markets,

- the current low level of inflation, and
- the looming scarcity of Treasury securities as budget surpluses erase the Federal debt (I'm not quite sure I buy that one).

Third, high-grade corporates have not been an unfailing source of safety. The February 7 Journal story referenced above included the observation that "of corporate bonds rated investment grade, an unprecedented 3% fell 30% or more in price last year, according to Merrill Lynch & Co."

The pundits - As usual, the cresting of stocks in 1999/early 2000 was caused and/or accompanied by the vesting of special powers in "experts." I have previously railed against the brokerage house analysts who set price targets based on where they guessed a stock could sell and gave out "buy" ratings to drum up corporate finance business.

The current targets for my wrath are the talking heads from CNBC and its competitors. I resent the role they played in the popularization of equity investing, in the bubble that developed, and in the debacle that followed. They're glad to opine on what stocks are worth, why they went up or down yesterday, and what they're going to do tomorrow. But the more I listen, the more I feel the absence of a few key phrases like "beats the heck out of me" and "darned if I know." I think one of the elements that roped in so many people and convinced them they could invest safely despite their lack of expertise was the media's repeated message that these things were knowable. Some of the confidence of these personalities has evaporated of late.

The Fed – The trend of personalizing described above reached its apogee in the deification of Alan Greenspan. For almost fourteen years, Greenspan has done an excellent job at the Fed. He kept a weather eye out for signs of inflation and took steps to avert it when needed. He wisely injected liquidity into the financial system in times of crisis. And he made every effort to keep a steady hand on the economy, trying to avoid sudden moves that could unsettle the participants.

He has presided over a terrific economy; I can't imagine a better one. I phrase that carefully, because it will be debated whether he made it great or it made him great. People who know things I don't will decide the question.

In January, the markets demonstrated their great faith in Greenspan by leaping forward when the first interest rate cut was announced. "Surely Greenspan will be able to avoid a cessation of growth." Investors were highly confident that he would be able to save them. Yet in 1998-9, when he as good as said "I'm going to slow the economy and rein in this irrational exuberance," no one acted as if he could, and the market continued to roar.

That is, investors first disregarded his power to throw cold water on the party but later had great faith that he could keep it going. I think this demonstrates their lack of objectivity and the selectiveness of their perception. No one can build the perpetual motion machine investors hope for, but that doesn't mean they'll stop hoping.

The sure thing – In fact, that brings me to the bottom line. Even though people have always looked for the silver bullet, the easy answer and the free lunch, there is no such thing. "Hope springs eternal," they say, or is it greed? Everyone wants the riskless route to riches, but markets exist to make sure it can't exist for long.

No one has all the answers. Lots of people can guess the direction of the market once or twice, or pick the right stock or group, but very few can do it consistently. That doesn't keep investors from following the latest Messiah who's been right once in a row. But no one seems to ask "if he knows what's going to happen, why is he telling me?"

No rule is valid all the time. Buy growth; buy value. Buy large-cap; buy small-cap. Buy domestic; buy international. Buy developed; buy emerging. Buy momentum; buy weakness. Buy consumer; buy tech. I've seen them all.

There is no perfect strategy. People flocked in droves to growth stock investing, real estate, portfolio insurance, Japanese stocks, emerging market stocks, tech stocks, dot-corns and venture capital. Each worked for a while and sucked in more and more investors. But in each case, success eventually pulled in enough money to guarantee failure.

Over the years, performance has constantly improved in areas like golf. That's because while the participants develop new tools and techniques, the ball never adjusts and the course doesn't fight back. But investing is dynamic, and the playing field is changing all the time. The actions of other investors will affect the return on your strategy. Just as nature abhors a vacuum, markets act to eliminate an excessive return.

So Then What Do We Do Now?

I have a few things to suggest that may help in the years that lie ahead. None of them will prove easy to implement, however. None will give you that sure thing.

Accept change – Among the important elements that clients, consultants and managers must possess is adaptability. The only thing you can count on is change. Even if the fundamental environment were to remain unchanged – which it won't – risk/return prospects would change because (a) investors will move the prices of assets, certainly in relative terms, and (b) investor psychology will change. That's why no strategy, tactic or opinion will work forever. It's also why we have to work with cycles rather than ignore or fight them.

Search for alpha – In doing so, however, it's essential to understand:

- what alpha is,
- what markets permit it, and
- who has it.

To me, **alpha is skill**. It's the ability to profit from things other than the movements of the market, to add to return without adding proportionately to risk, and to be right more often than is called for by chance.

More important, **alpha is differential advantage**; it's skill that others don't possess. That's why knowing something isn't alpha. If everyone else knows it, that bit of knowledge gives you no advantage.

Lastly, **alpha is entirely personal**. It's an art form. It's superior insight; some people just "get it" better than others. Some of them are mechanistic quants; others are entirely intuitive. But all those I've met are extremely hard working.

You want managers who have alpha, and you want them to be working in markets that permit it to be put to work. Only in markets that are not efficient can hard work and skill pay off in consistently superior risk-adjusted returns. I always say if you gave me 20 Ph.D.s and a $100 million budget, I still couldn't predict the coin-toss before NFL games. That's because it's something into which no one can gain superior insight. When someone says "my market is inefficient" or "I have alpha," make him prove it.

You want to be sure the claimed alpha is there. Just about everyone in this business is intelligent and articulate. It's not easy to tell the ones with alpha from the others. Track record can help but (a) it has to be a long one and (b) it's still possible to play games.

My advice to you is that when you find managers who do what they promise and seem to do it well, stick with them. Even the best manager won't be infallible, but staying with those who've demonstrated skill and reliability will reduce the probability of disappointment. I don't expect much out of market returns in the years ahead, so alpha will be more important than it was in the 1990s.

Pursue non-market-based returns – The period since I started managing money in 1978 has been incredible. There were a few bad days and quarters, but through 1999 there wasn't a single year with a return on the S&P 500 worse than minus 4.8%. From 1978 through 1999, the return on the S&P 500 averaged 17.6% per year. 111at rose to 20.6% for 1991-99 and 28.3% for 1995-99. I doubt there's ever been a better 22-year run; to ask for more would be just plain piggish. But I don't think it'll be anything like that in the years just ahead.

The observers I most respect foresee single digit returns. Stock market returns have three components: profit increase, multiple expansion and dividend yield. The last is minimal and the second can't be counted on from here. So that means we're down to the rate of increase in corporate profits, which is likely to be in single digits. Returns like that would be somewhat below the historic average, but after such a great 22-year period, a little correction wouldn't be unreasonable.

So if stocks are poised for unexciting single-digit returns, (and if the period ahead may be marked by more negative surprises than the recent past, which I believe), what looks promising? I suggest you search for returns that are not predicated on market advances.

Coupon interest provides a good start, so high yield bonds and convertibles are likely candidates. Distressed debt is an example of a non-prosperity-oriented strategy that should work well.

Lastly, I would take a good look at "absolute return-type" strategies. These are designed to systematically take advantage of market inefficiencies and to capture managers' alpha while limiting susceptibility to fluctuations. Arbitrage, long/short, hedge and market-neutral strategies fall into this category. Most strive to earn returns in the teens on a consistent basis, with relative indifference to the performance of the mainstream markets.

I think investors are about to move into these areas en masse for a number of reasons:

- because they did well in recent years, and especially well amid the chaos of 2000,
- because of the pain inflicted by stocks over the last twelve months, and
- because of the modest prospects in the mainstream markets.

I expect hedge funds and absolute return funds to be promoted heavily by brokerage firms, mutual fund organizations and investment advisers and to become the next investment fad. And there's good reason why they should. Especially given the competition from the mainstream, an appropriate mantra for the 2000s might be "low double digits ain't bad." If you can identify managers who possess enough alpha to consistently deliver such returns, you should hire them. And there's a better-than-average chance they'll be found in the hedge fund arena, where managers get a share of the profits.

However, that doesn't mean a few caveats aren't in order:

- **Expectations must be reasonable**. Investors must realize that very few managers are truly capable of earning 12% or 15% steadily and with low correlation to the mainstream markets. Anything approaching 20% is Herculean.

- **Most returns really won't be "absolute."** I have seen lots of "hedge" and "market neutral" funds drop precipitously. That's because it's unusual for portfolio returns to be entirely divorced from their environment. For example, one of the things currently attracting attention is the excellent performance of risk arbitrage last year. But something systematically favorable may have occurred in 2000, and thus it could turn systematically unfavorable in some future year. I've often said "zero correlation" may not be attainable; "low correlation" may have to suffice.

- **Money flows will playa big role**. In general, the good records have been built on small amounts of money. And those records will attract large amounts of money. There are several consequences.

  First, records simply may not be capable of extrapolation. To handle more money, a manager may have to invest faster, put more dollars into each position, put on a larger number of positions, broaden the fund's range of activities, add new staff members and/or reduce selectivity. All of these can have negative implications. George Soras and Julian Robertson had terrific records, but they eventually reached $20 billion and lost their specialness.

Second, many of the best managers with alpha and discipline are already closed to new money, or will reach the point when they are. Thus in the extreme, as Groucho Marx would have put it, "I would never invest my money with anyone who'd take it."

And third, when there's too much money in an area, even funds that are closed can be affected. Long-Term Capital found others emulating its trades and eventually lost its opportunity because too much money had piled into its niches.

- **The wrong people will get money**. The rush to invest in an area gives money to managers who shouldn't get it. **When the best are closed, the rest will be funded**. Second-string managers will split off from established groups and get money based on their old fund's record (regardless of how much of it was theirs). Thus, as the amount of money in the area rises, the average quality of the managers may fall.

- **Fees can eat up alpha**. When the demand for funds outstrips supply, fund managers have the ability to raise fees and thereby appropriate for themselves a larger portion of their funds' returns.

- **Disappointments will be many**. Due to the factors enumerated above, the next few years will see many investors fail to get what they hoped for . . . as usual. One of my favorite sayings is "what the wise man does in the beginning, the fool does in the end." Over the last 20-30 years, a few talented managers built successful hedge funds on relatively small amounts of capital. I believe the period ahead will see lots of people raise more than they should; thus it will have to be navigated with care.

Investment trends certainly run the risk of being carried to extremes. (For an example, take a look at venture capital in 2000.) Despite this, I think absolute return investing deserves your attention. But you should commit only after a lot of investigation and with your eyes wide open. No process, no label, no strategy will deliver performance in and of itself. Exceptional low-risk performance requires a partnership between skillful, disciplined money managers and insightful, hard-working clients.

April 10, 2001

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