Memo to: Oaktree Clients

From: Howard Marks

Re: What Lies Ahead?

Writing my client memos gives me great satisfaction. I appreciate the opportunities to share my views with you as well as your receptivity to them. Setting down my "Notes from New York" did me a lot of good as my way of dealing with post-attack issues outside the investment arena.

I must admit that I haven't been looking forward to writing a memo about the economic and investment implications of the attacks. Many of my views are negative, and I'm no economist. But I want to give you the benefit of my thinking, such as it is.

Looking to the Future – All of economics, business and investing entails dealing with the future. Economists predict future conditions. Businesspeople build and manage organizations so as to profit in the coming environment. And, of course, investors try to figure out what things will come to be worth in the years ahead and act accordingly. Other professions deal more with the past (e.g., accountants and historians) or the present (doctors and lawyers), but it is our job to cope with the future.

That's what makes investing interesting, challenging and occasionally lucrative. If it didn't require us to reach conclusions about the future, or if the future wasn't uncertain, then everyone's returns would be the same – but not very high. We achieve high returns on occasion because we deal with an uncertain future, and it's because the future is uncertain that superior investors can get an edge.

The process of investing consists entirely of divining the future – in terms of profits and values – and translating that future into prices that should be paid today. Obviously, doing so requires a view of what the world will look like tomorrow and how businesses and their products will fare in that world.

We each make thousands of judgments a day based on our understanding of what's normal. We turn the right faucet for a drink because that's where the cold water always has been. We tend to buy another car – or another tube of toothpaste – of the same brand because we were happy with the last one. We cross the street on a green light because we trust on-coming drivers to stop on red.

We must make assumptions like these, even though we know they won't hold true all the time. If we had to start from scratch every time we faced a decision, the result would be paralysis. Thus we start by assuming that the things that worked in the past are likely to work in the future, but we also make allowances for the possibility that they won't.

We do the same in our roles as investors. We expect well-managed companies with good products to make money and be valued accordingly. We assume companies that have the money will service their bonds. We count on the economy to recover from slowdowns and grow over time.

So most of our actions depend on extrapolation. Certainly in investing, we rely on forecasts that assume the future will look a lot like the past. And most of the time they're right. My main quibbles with forecasters are two:

1. While most forecasts call for a future that's a lot like the past, the truly valuable forecasts are those that call for radical change. Forecasters rarely make such forecasts, however, and those who do are rarely right.

2. Most forecasters present their work as deserving more credence than it does. In short, they rarely say, "Here's my forecast, and if I were you, I'd take it with a grain of salt."

Even today, forecasters are out there with predictions for the economy and the market that are based primarily on history. And yet it seems to me that the future may be less likely to look like the past than it has until now, and that things we've never even considered before have a chance of happening.

Immediately after the attacks, there began to appear articles citing how long it has taken the market to recover after past crises. But who's to say those precedents are at all relevant? For example, I read that the market sagged for five months after Iraq's invasion of Kuwait but made up all of that ground, and then some, soon thereafter. But that experience had a very favorable outcome. We all want this one to be as good and as quick, but are we willing to bet that it will?

We all want a feeling of assurance. We want to live in a world where the future seems knowable and decisions that extrapolate normalcy can be depended on. We want to believe life in this country will return to the carefree days pre-September 11. We want to believe our leaders will be able to keep the ship upright and manage their way out of problems. So I think we're eager to embrace predictions that these things will hold true. **But is it prudent today in making decisions regarding the future to assume a return to the status quo?**

The New Future – It seems to me that today we know even less about the future than we usually do, and that's never a lot.

1. About terrorism. How much of what we have to worry about stems from Osama bin Laden and al Qaeda, and how much relates to other groups? How much of bin Laden's plans and resources went into the September 11 attacks, and how much remains on tap? Is bin Laden a diabolical genius against whom we're powerless, or a paper tiger who got lucky? Are there additional shoes left to drop? Will there be a high-profile attack once a year? Or will Middle East-style violence

intrude into our regular existence? Are chemical and biological weapons a real threat?

2. About our response. Can we find bin Laden? Can we capture him and his henchmen? Will our military actions be successful, and can they be undertaken without extensive collateral damage? Can we pursue justice without alienating people and nations? Will terrorists move to punish our actions? Will their doing so shake our resolve, or that of our allies?

3. About the economy. How deep a recession are we in for? How long will it last? What will prompt a recovery, and what shape will it take? Will industries like airlines and hotels be permanently depressed, or will they return to pre-9/11 normalcy? When will liquidity and a desire to buy things return? Can we rely on normal cyclical patterns in these things? Will these elements be set back again if there is further terrorism?

Who among us can say he knows the answers to these questions? And who can say the future is foreseeable without those answers?

Many of these questions take us into uncharted territory where no one can say what will happen. The possible answers include some that could profoundly affect the economy and the markets, and they worry me. **Some of the greatest dilemmas in investing surround highly unlikely events with highly negative implications**. It's hard to know what to do about them, but we should at least be aware of their existence.

We have no alternative to assuming that the future will look mostly like the past, but we also must allow for the fact that we face a range of possible futures today that is wider than usual. In other words, I feel we must allow for greater-than-normal uncertainty.

The Role of Confidence – The basic building block underlying all economic activity is the individual spending unit, be it a business or a household. Each of these units builds into its decisions expectations regarding the future. And those expectations are shaped to a great extent by the data, opinions and emotions that add up to **confidence**. Sometimes I think in the economy, confidence is all there is.

When people are confident, they extrapolate prosperity and borrow and buy. They assume an upward-sloping future and want to jump on board. They worry that if they don't buy something today, it'll cost them more tomorrow. That is, they are concerned about the cost of inaction.

When their confidence fades, they worry about losing jobs and defer purchases. They may prefer to build cash or pay down debt. They're willing to wait before buying, and they assume there'll be another chance to buy cheaper. In other words, they figure that if they don't act, they won't miss out on much. Opportunity costs just don't seem that important.

Who would say that confidence wasn't shaken by the events of September 11? Words we would have applied to our domestic security before, like insulated, invulnerable and impregnable, now seem to be out the window. Who doesn't feel at least a little less safe than a month ago? Thus most people are less full of the positive feelings that are required for a purchasing or investing decision, and on average they may "hunker down."

Many economic units have concluded that in this more uncertain world, greater cash reserves are in order – for rational as well as emotional reasons. Individuals fear that jobs will be lost, hiring will be slow, and bonuses and raises will be less generous – and they know they've saved too little and tapped their home equity to keep spending. Home and car purchases will be deferred. Business investment will be slow, especially given that capacity utilization was low and falling even prior to September 11. Each of these decisions will take away a potential source of growth from the economy and contribute to a slowdown. That's what makes for the down-leg of the economic cycle (and we believe one has been well under way for several months).

And when every expenditure that can be delayed has been delayed, the decline will slow and then stop. Then one person will conclude it's not going to get any worse, or prices any lower. One potential buyer will come off the sidelines and place an order; one worker will be hired to fill that order; and one manufacturer will buy a new machine in anticipation of increased business. And one person will decide to buy a share in a business, or even try to start one. And that's what gets the up-leg going.

It's all based on the ebb and flow of psychology. In my opinion, the key question is "How long will it take to restore confidence?" I don't claim to have the answer, but I think it may be a while.

Stimulative Actions – The federal government has acted boldly to combat economic weakness, as it has been doing all year. All economic trends start at the margin, and that's where the government's actions can help. They can keep things from getting as bad as they otherwise would have gotten – but they cannot call the tune.

Immediately providing a record amount of liquidity to the financial system prevented some problems that otherwise would have arisen given the damage to our infrastructure. Difficulties in the movement of funds and settlement of securities transactions were avoided, enabling the system to work and Americans to maintain faith in it. Prompt monetary action worked again to avert a potential crisis, as it did in 1987 and 1998.

Fiscal policy, which relates to taxing and spending, also will have an impact. Government spending is stimulative, in that it uses money to purchase goods or to pay people who may turn around and spend it. Deficits put more money into the economy than they take out in taxes. (This is unlike the surpluses we thought we were heading for, which are restrictive because the government takes out more than it puts back.) In the weeks since the terrorist attacks, the administration has announced programs sufficient to consume the surplus that had been projected for the current fiscal year. These include $40 billion in emergency funds, $15 billion in subsidies and loans for the airlines, and

$60-$75 billion for "economic revival." In the short run, as CSFB says, this will "create a buffer to the slowdown in activity." (The long-term effects may be less positive, in that deficits and the Treasury borrowing required to support them can lead to inflation, higher interest rates and crowding out of non-government borrowers).

Interest rate reductions also can help ease the contraction, and we may see more of them. They will work at the margin, but I don't expect them to give the economy much of a boost in the short run. One of the most vivid phrases in the business vocabulary is "pushing on a string," and that's what rate reductions can amount to in a hunkered-down world. Will low interest rates get people to buy homes and cars if they've lost their willingness to spend? Will they work with people who realize they have inadequate savings and are overly indebted? Will they cause businesses to invest in expansion if they already have capacity sitting idle?

No one knows the answers to these questions, but they should not be assumed to be overwhelmingly positive. A discouraging analogy can be seen in Japan's decade-long doldrums. The government has pushed interest rates nearly to zero and keeps pumping money into the system. But every time the cautious Japanese citizen gets a few yen he puts it in the bank, and economic growth fails to revive. Hopefully, a difference may lie in Americans' higher propensity to spend.

So in the end, I feel it all goes back to confidence. Consumer and business spending will pick up at some point, and the government can encourage it, but it can't make it happen.

<u>Investor Reaction</u> – On September 17, after a four-day hiatus, the nation's financial markets reopened, with the Dow falling 685 points, or 7%. When I heard about that first day's loss, my reaction was immediate: "That's not so bad – just a quarter of the percentage decline in the crash of 1987." And after declining further in that first week of trading, stocks have recovered most of their losses.

Clearly, the interest rate cuts are helping stock prices. They make investors feel the Fed is doing something to improve the outlook. They contribute to economic activity at the margin. By reducing floating-rate mortgage payments they leave people with more spending money. And by lowering fixed income returns they reduce the competition that comes from cash and bonds, thus making stocks more attractive in relative terms.

But no one knows what the economic future will look like. No one knows what corporate earnings will be in 2001 or 2002, although they appear likely to decline. In addition, geopolitical uncertainties dot the horizon. Thus with the Dow off less than 6% from its September 10 pre-attack close, I wonder whether investors weren't shaken enough, or whether complacency has returned too quickly.

The Dow has risen 10% since the start of the recovery on September 24, including 200+ points this week. The stock market seems to be saying "Well, I'm glad that's over." Frankly, I worry about attitudes like those displayed in an article in yesterday's Wall Street Journal:

> Stock Investors Show a "Comfort" Level; Rate Cut Spurs 113.76-Point Rise
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> . . . the Fed said the Sept. 11 terrorist attacks "have significantly heightened" uncertainty in an already weak economy. Yet despite the Fed's concern, signs are spreading that some professional investors are gradually putting money back into stocks. "The market has reached a level that makes people feel a lot more comfortable that we have seen the worst of what could happen," . . .

I can't tell you how much I hope we've seen the worst, both in terms of world events and in the markets. But I am not willing to bet heavily on that assumption. And if I'm supposed to be more afraid when others are less afraid, articles like this one tell me there's plenty to worry about.

I always stress that investments must leave a substantial margin for error and allow for the possibility that negatives will arise. The terrorist attacks, while certainly not imaginable, show the importance of allowing for adverse surprises. Only when asset prices are clearly at irrationally low levels can this caution be ignored. In my view, with investors' sangfroid having bounced back so strongly, most stocks aren't at such levels.

<u>So What Do We Do Now?</u> – We could assume that the combination of further weakening of the already-weak economy plus continued terrorism will make for a very difficult environment. If we then based our investment process on that assumption, we would hold cash and make very few commitments. I call this "single scenario investing." The problem, obviously, is that arranging our portfolio so that it will succeed under a scenario as negative as that means setting it up to fail under most others. We do not believe in basing our actions on macro-forecasts, as you know, and we certainly don't think we could ever be that right.

Thus Oaktree will continue to invest under the assumption that tomorrow will look a lot like yesterday – an assumption that to date has always proved correct.

At the same time, we will continue to insist on an investment process that anticipates things not always going as planned, and on selections that can succeed under a wide variety of scenarios. As long-term clients know, this part of the story never changes. **In the current environment, we will allow a very substantial margin for error.**

We will continue to work only in inefficient markets, because we feel it's there that low risk needn't mean low returns, and upside potential can coexist with downside protection.

And we will continue to strive for healthy returns in good markets and superior returns in bad markets. We do not promise to beat the markets when they do well, but we also don't think that's an essential part of excellence in investing.

<u>Will I Ever Drop My Cautionary Stance?</u> – On September 24 the Los Angeles Business Journal printed excerpts from an interview with me (and a pretty accurate one overall) under the title "A Bear's Eye View." Because I wasn't crazy about that title, I was glad soon thereafter to receive the following e-mail from my partner Steve Kaplan:

> I have never viewed you as, nor do I believe you are, a pessimist. To the contrary, I think you have an optimistic view when it comes to things you believe you can control. . . . Your caution revolves around the uncontrollable, for which you recognize that a lot of the judgments of the so-called experts are in large part pure guesswork.

I greatly appreciate Steve's comments, and I think – and hope – he got it right. I have no interest in being a pessimist or a bear, and I don't like to think of myself that way. I just may be more impressed by the unknowability of the future than most people. When I reflect on all of the mottoes I use, it seems half of them relate to how little we can know about what lies ahead.

Am I right or wrong in being this cautious? No one can say. Does my mindset, and Oaktree's resultant approach to investing, cost us profits in good years? Probably. Are we well prepared for bad times and untoward developments, and are we happy with that? Absolutely. **If we insist on a degree of defensiveness that turns out to be excessive, the worst consequence should be that your profits will be a little lower than they otherwise might have been. I don't think that's the worst thing in the world**. And in the end, I think the skill, experience and discipline of Oaktree's people will continue to make up for its lower risk profile and keep our long-term returns more than competitive.

The longer I'm in this business, the less I believe in investor agility. Most people seem stuck in positions as bulls, bears or something in between. Most are always aggressive or always defensive. Most either always feel they can see the future or never feel they can see the future. Most always prefer value or always prefer growth. Few people's psyches are flexible enough to allow them to switch from one way of thinking to another, even if they theoretically possessed the needed perspicacity. Rather, most people have a largely fixed style and point of view, and the most they can hope for is skill in implementing it – and I don't exempt Oaktree and myself from that observation.

But that's not so bad. It's my conclusion that if you wait at a bus stop long enough, you're sure to catch your bus, while if you keep wandering all over the bus route, you may miss them all. **So Oaktree will adhere steadfastly to its defensive, risk-conscious philosophy and try to implement it with skill and discipline. We think that's the key to successful long-term investing – especially in today's uncertain environment**.

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